

ARTICLE

THE MCCARRAN-FERGUSON ACT OF 1945: RECONCEIVING THE FEDERAL ROLE IN INSURANCE REGULATION

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Among America's financial institutions, insurance firms alone are largely immune from federal regulation. The liability insurance crisis of recent years and the well-publicized failures of several major insurance companies have sparked calls for federal regulation of the insurance industry. In this Article, Professors Macey and Miller examine the exemptions from federal regulation provided in the McCarran-Ferguson Act. The authors first examine the statutory allocation of regulatory power among the state and federal governments and posit a model of regulatory federalism describing the existing system. The authors then apply this model to assess three issues. Considering first the insurance industry's broad exemption from antitrust regulation, the authors argue that the exemption should be interpreted to allow the sharing of historical loss cost data, but not of data on profitability or other costs. Turning next to the issue of solvency regulation, the authors conclude that federal solvency regulation would be unwise, but suggest that the Federal Reserve Board assume a role as lender of last resort. Finally, the authors argue that insurance rates should be set by market forces, not regulatory agencies, rejecting calls for increased federal involvement in rate regulation.

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INTRODUCTION

Among major financial institutions in the United States, only insurance firms are subject to plenary state regulation. The federal government not only has eschewed regulation; it has affirmatively declared a policy of *not* regulating the business of insurance. This is so even though the U.S. insurance industry is the largest in the world, receiving \$431 billion in premium income in 1988, an amount representing thirty-seven percent of the total insurance premium volume worldwide.¹

The policy against regulating insurance is found in the McCarran-Ferguson Act of 1945,² which provides, in pertinent part, that "[t]he business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business."³ The Act declares that "the continued regulation and

¹ See Insurance Info. Inst., *Insurance Facts* 15 (1991).

² 15 U.S.C. §§ 1011-1015 (1988).

³ *Id.* § 1012(a).

taxation by the several States of the business of insurance is in the public interest, and . . . silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.”⁴ It further provides that “[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance.”⁵

In the antitrust field, the statute provides, somewhat more ambiguously, that the Sherman Act, the Clayton Act, and the Federal Trade Commission Act shall apply to the business of insurance “to the extent that such business is not regulated by State Law.”⁶ The statute also preserves against the insurance industry, despite the presence of state regulation, a number of other statutes: the National Labor Relations Act, the Fair Labor Standards Act, and the Merchant Marine Act.⁷

Although anomalous, the insurance industry’s exemption from federal regulation was not particularly controversial until the 1980s. However, that decade’s liability insurance crisis⁸ and the failures of several major insurance companies⁹ have sparked renewed interest in the McCarran-Ferguson Act, much of it critical. Members of Congress have held hearings¹⁰ and introduced legislation¹¹ to overturn the antitrust ex-

⁴ Id. § 1011.

⁵ Id. § 1012(b).

⁶ Id.

⁷ Id. § 1014.

⁸ During this period, particularly 1985-1986, liability insurance rates skyrocketed throughout the country and, in some cases, insurance became unavailable altogether. Particularly hard-hit were school boards, municipalities, charities, and smaller businesses. See generally Kenneth S. Abraham, *Making Sense of the Liability Insurance Crisis*, 48 Ohio St. L.J. 399 (1987).

⁹ Such companies include: the Executive Life Insurance Companies of California and New York, which were, respectively, the 33rd and 85th largest firms in the North American life insurance industry in 1990, with admitted assets of \$10.2 billion and \$3.2 billion, respectively; Mutual Benefit Life Insurance Company, which was the 21st largest North American insurance firm in 1990, with admitted assets of \$13.8 billion; and Monarch Capital Corp., the parent of Monarch Life Insurance Co., which was the 66th largest North American insurance company in 1990, with admitted assets of \$4.5 billion. See Susan Pulliam, *Mutual Benefit Life is Expected to Ask State to Take Over as Early as Today*, Wall St. J., July 15, 1991, at A3; Life & Health Statistical Rev., Nat’l Underwriter (Life & Health/Fin. Serv. Ed.), June 10, 1991, at S3.

¹⁰ See, e.g., *The Insurance Competitive Pricing Act of 1991: Hearings on H.R. 9 Before the Subcomm. on Economic and Commercial Law of the House Comm. on the Judiciary*, 102d Cong., 1st Sess. (June 13, 1991) [hereinafter H.R. 9 Hearings].

¹¹ See, e.g., H.R. 9, 102d Cong., 1st Sess. (1991) (introduced by Rep. Jack Brooks); S. 430, 102d Cong., 1st Sess. (1991) (introduced by Sen. Metzenbaum). H.R. 9 was reported out of subcommittee on November 14, 1991, and out of the full House Judiciary Committee (with amendments) on November 19, 1991. The full House failed to act on the legislation, however. Congressman Brooks reintroduced legislation to repeal the antitrust exemption in 1993. See

emption.¹² The General Accounting Office¹³ and powerful congressional committees¹⁴ have criticized the ways in which state regulators handle financially troubled insurers, and proposals have been aired in Congress

NAII Blasts House Bill Limiting McCarran Act, J. Comm., Jan. 21, 1993, at A11.

The powerful National Association of Professional Insurance Agents opposed this measure because of its adverse effects on independent insurance agents. See *Compromise Isn't Imminent on Bill to Alter McCarran-Ferguson Exemption*, 62 *Antitrust & Trade Reg. Rep.* (BNA) No. 1569, at 757 (June 11, 1992).

¹² Those powerful and well-organized political forces which favor the repeal of the antitrust exemption include the National Association of Attorneys General, major consumer groups, and the commercial banking industry, which is seeking entry into insurance markets. See H.R. 9 Hearings, *supra* note 10, at 20 (Statement of George W. Sampson, Assistant Attorney General of New York); *id.* at 52 (Statement of J. Robert Hunter, President, National Insurance Consumer Organization). Important periodicals have also begun to weigh in against the antitrust exemption. See, e.g., *Bust the Insurance Cartel*, N.Y. Times, May 4, 1991, at A22; *End McCarran-Ferguson*, J. Comm., May 25, 1988, at A8; *The Insurance Cartel is Ripe for Busting*, Bus. Wk., Apr. 11, 1988, at 138.

Groups opposing repeal of the antitrust exemption include the Alliance of American Insurers, the American Council of Life Insurance, the Health Insurance Association of America, the National Association of Independent Insurers, the National Association of Life Companies, the National Association of Mutual Insurance Companies, and the National Association of Life Underwriters. See H.R. 9 Hearings, *supra* note 10, at 46 (Statement of S. Roy Woodall, Jr.); Tracey L. Longo, *Changes to Come*, Fin. Serv. Wk., June 24, 1991, at 15.

The insurance industry traditionally has presented a united front against efforts to repeal or weaken the antitrust exemption. However, some strains have appeared within the industry itself. The American Insurance Association (AIA), whose members include some of the larger insurance firms, opposed outright repeal of the exemption but indicated that it would be receptive to a "safe-harbor" bill. The AIA, however, was unable to strike a compromise with repeal advocates on the House Judiciary Committee. See Paul Dykewicz, *Insurer Group Quits Talks with Panel on Antitrust Bill*, J. Comm., May 29, 1992, at A8. In addition, some individual industry leaders have expressed the view that their firms do not need the protection of the McCarran-Ferguson Act. See, e.g., Richard L. Hall, *If Solvency Is a Problem, Is Federal Regulation the Solution*, Best's Rev. (Property/Casualty Ins. Ed.), Oct. 1991, at 108 (reporting remarks of Caleb L. Fowler, President of CIGNA Property & Casualty Companies).

The current movement to change the antitrust exemption can be dated from the Report of the National Commission for the Review of Antitrust Laws and Procedures 225-51 (1979). The Report recommended repeal of the McCarran-Ferguson Act's antitrust immunity, to be replaced by "narrowly drawn legislation . . . to affirm the lawfulness of a limited number of essential collective activities under the antitrust laws." See also American Enterprise Institute for Public Policy Research, *Federal-State Regulation of the Pricing and Marketing of Insurance* (P. MacAvoy ed., 1977) [hereinafter AEI Study] (influential earlier study favoring market mechanisms for rate setting).

¹³ See, e.g., General Accounting Office, *Insurance Regulation: Assessment of the National Association of Insurance Commissioners* (1991) (testimony before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce); General Accounting Office, *Insurance Regulation: State Handling of Financially Troubled Property/Casualty Insurers* (1991); General Accounting Office, *Problems in State Monitoring of Property/Casualty Insurer Solvency* (1989); General Accounting Office, *Questions and Concerns about Solvency Regulation* (1991).

¹⁴ See, e.g., Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce, 101st Cong., 2d Sess., *Failed Promises: Insurance Company Insolvencies* (Comm. Print 1990).

to subject the insurance industry to federal regulatory oversight.¹⁵ Others have called for the establishment of a presidential commission to review and report on the financial health of the insurance industry.¹⁶

Developments outside the Capitol Beltway also have altered the political situation. Several states—notably California, New Jersey, and Texas—have begun to impose much more stringent regulations on the insurance industry.¹⁷ A number of states have repealed their “mini-McCarran-Ferguson Acts” which exempted the business of insurance from state antitrust laws, and other states have begun to enforce their antitrust laws with greater vigor.¹⁸ These developments have considerably reduced the perceived value of the antitrust exemption for many insurance companies.

These recent events suggest the potential value of a comprehensive review of the McCarran-Ferguson Act’s pattern of regulatory federalism. This Article attempts such a reevaluation, focusing on potential reforms in the areas of the antitrust exemption, solvency regulation, and rate regulation. Based on our findings, we suggest the following modifications to the Act.

First, *the antitrust exemption should be interpreted in such a way as to allow vigorous enforcement against industry practices that threaten competition, while permitting efficiency-enhancing cooperative activities in the areas of information sharing and analysis and the development of standardized forms.* The goal of antitrust regulation of the insurance industry should be to protect and enhance competitive forces. The McCarran-Ferguson Act therefore should be interpreted to permit vigorous enforcement against industry practices that suppress or threaten to suppress competition. This indicates a relatively expansive interpretation of the boycott exception to the Act. Similarly, state action immunity should be limited to situations in which the activities in question are both (1) en-

¹⁵ Proposals for federal solvency regulation do not appear likely to gain congressional approval in the near future, however. See, e.g., Steven Brostoff, *Feds Unlikely to Pass Insurer Regs* in 1993, *Nat’l Underwriter*, Mar. 15, 1993, at 4.

¹⁶ See S. 1276, 102d Cong., 1st Sess. (1991) (Presidential Insurance Commission Act); Mary Jane Fisher, *Senators Seek Presidential Commission on Insurance*, *Nat’l Underwriter*, June 24, 1991, at 2.

¹⁷ In 1988, California required a rollback of insurance rates and applied its antitrust law to insurance regulation as a result of a ballot referendum (Proposition 103). See 1988 Cal. Legis. Serv. Prop. 103 (West). In June 1991, Texas enacted major insurance reform legislation, the Omnibus Insurance Reform Bill of 1991, that, among other things, strengthened solvency requirements, established an office of public insurance counsel to represent consumers in insurance rate-setting proceedings, and repealed the insurance industry’s exemption from the state antitrust laws. See 1991 Tex. Sess. Law Serv. ch. 242 (Vernon). New Jersey enacted legislation in 1990 to roll back automobile insurance rates. See 1990 N.J. Sess. Law Serv. ch. 8, § 53 (West).

¹⁸ See notes 137-38 and accompanying text *infra*.

dorsed by express state legislation or regulation, and not merely permitted as a matter of administrative practice or authorized by implication, and (2) subject to active, continuous, and meaningful state oversight.¹⁹

At the same time, however, the insurance industry is subject to special economic problems that do not affect other industries to the same extent. In particular, casualty and liability insurance firms need to be able to share loss information in order to facilitate accurate pricing of insurance products. Therefore, cooperative efforts at sharing and analyzing historical loss cost information should be protected against antitrust scrutiny. Similarly, accurate information cannot be developed—and consumers cannot easily comparison shop on the basis of price—unless firms in the industry have access to standardized forms. Cooperative efforts to develop standardized forms thus should be protected against antitrust scrutiny as well, although efforts to coerce insurers to use any particular form or forms should be subject to review under the boycott exception to the Act.

In general, recent interpretations of the McCarran-Ferguson Act have adopted a reasonable construction of the antitrust exemption. Thus, we do not believe that the Act is currently in need of fundamental modification or repeal. If, however, the antitrust exemption receives a judicial construction that interferes with the power of the federal antitrust laws to police against threats to competition within the industry, we then would recommend that Congress consider legislation to provide explicit safe harbors for economically efficient cooperative activities that do not pose serious threats to competition—such as the sharing and cooperative analysis of historical loss data and the cooperative development of standardized forms.

Second, *solvency regulation should be left to the states*. There is no convincing evidence that state solvency regulation is fatally flawed or that federal solvency regulation would be better than the existing system. Despite a few recent failures, the overall level of insurance company insolvencies has been extraordinarily low, and the insolvencies that have occurred frequently have been triggered by unforeseeable downturns in real estate and corporate debt markets. There is also little evidence to suggest that insurance companies are failing due to lax supervision. Even if state insurance departments historically exercised insufficient scrutiny over some insurance companies, state insurance regulators are moving rapidly to increase the stringency of their solvency regulations.

Moreover, the federal government certainly has not acquitted itself well in the analogous field of banking regulation, where the largest financial catastrophe in the history of the United States has recently occurred,

¹⁹ See notes 178-92 and accompanying text *infra*.

partly as a result of inadequate regulatory supervision by federal banking agencies. Compared with the banking industry, which is heavily regulated at the federal level, the insurance industry, with plenary state regulation, is a stunning success story. Accordingly, after a century and a half of successful state regulation, no persuasive arguments exist for federal solvency regulation at this time.

Nevertheless, a limited role for the federal government as a lender of last resort might be warranted in solvency regulation. Such assistance should be available to solvent firms on a fully collateralized basis to solvent insurance companies faced by policyholder runs, or to property/casualty firms faced with sudden systemic demands on their assets as the result of a major disaster. The logical candidate to serve as such a lender of last resort would be the Federal Reserve Board, since it already performs a similar function for the banking industry. While it is unlikely that there would be an extensive insurance industry call on the Federal Reserve Board for liquidity loans, the advantages of temporary liquidity assistance are sufficiently great to warrant this extension of the federal role.

Finally, *insurance rates should be set by market forces*. Setting insurance premiums through regulation rather than through the market will result in rates that are either too high or too low, will produce distortions and shortages, will harm both consumers and producers, and will require costly government enforcement efforts as well. In the absence of government control or private cartelization, marketplace forces will function effectively to set rates at optimal levels in this highly competitive, unconcentrated industry.

Over the past twenty years, the trend among the states has been to allow greater use of free market rate setting. However, several states have recently returned or considered returning to state-controlled rates in one form or another. Other states now impose penalties or "exit taxes" on insurance firms that leave the state rather than comply with its rate regulations. These "lock-in" rules undermine longstanding marketplace checks against state expropriation of insurance industry assets, and in the long run they may well harm consumers (by reducing the supply of insurance), undermine industry solvency, and spark an unhealthy competition in which states vie to set rates at unrealistically low levels in order to benefit their own citizens at the expense of the national interest.

As yet, this unfortunate trend towards administrative rate setting is not so pronounced as to suggest the need for preemptive federal rate regulation. However, the problem of exit fees is serious enough to warrant limited preemptive regulation, which would prohibit states from penalizing firms that leave a state's market or stop providing any line of insurance within a state's market, if the firm's decision is based on economic

cost factors and is not part of any boycott or cooperative enterprise.

These federal roles under the McCarran-Ferguson Act can be evaluated best against the backdrop of the Act itself and the pattern of regulatory federalism it establishes. Accordingly, Part I of this Article examines the statutory allocation of regulatory power between the state and federal governments and how the statutory language has been interpreted by the courts. Part II analyzes the case for rethinking the federal role in insurance regulation, focusing specifically on the antitrust exemption, solvency regulation, and rate regulation.

I

REGULATORY FEDERALISM IN INSURANCE: ESTABLISHING THE BOUNDARIES OF STATE AND FEDERAL AUTHORITY

The McCarran-Ferguson Act is unusual—perhaps unique—in the extraordinary deference it displays towards state regulation.²⁰ Many federal statutes provide for mixed regulatory systems in which the states play a prominent role. But few, if any, other statutes expressly assign the states exclusive regulatory jurisdiction over an area of commerce or so clearly disavow the value of federal regulation.

A. State Regulation of "The Business of Insurance"

As noted above, the McCarran-Ferguson Act provides that "[t]he business of insurance . . . shall be subject to the laws of the several States,"²¹ and that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance."²² The statute leaves undefined the somewhat vague phrase, "the business of insurance," and that phrase arguably is subject to a relatively wide range of interpretations.²³

²⁰ The pattern in the insurance industry is particularly remarkable when compared with that applicable in related financial services industries such as banking and securities. The securities industry was essentially unregulated at the federal level until 1933. See Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 *Tex. L. Rev.* 347, 348 (1991). Since that time, however, Congress, the courts, and the SEC steadily have increased federal oversight to the point that state "blue sky" laws are minor, although still important, actors in the regulatory drama. See *id.* Similarly, the banking industry also has been subjected to steadily increasing federal regulation, following the adoption of the Banking Act in 1863 and the creation of a system of national banks. See Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 *Cornell L. Rev.* 677, 678 (1988) ("Federal preemption and uniformity, rather than competition and diversity, are the legal norms in banking regulation.").

²¹ 15 U.S.C. § 1012(a) (1988).

²² *Id.* § 1012(b).

²³ For cases interpreting the phrase "the business of insurance," see 15 U.S.C.A. §§ 1011-1015 *annot.* (Validity, Construction, and Application of McCarran-Ferguson Act) (1988); *Dealing with Regulation of Insurance Business by State or Federal Law*, 21 *L. Ed.* 2d 938

For instance, "the business of insurance" might be defined narrowly to include only the actual contract of insurance by which risk is passed from the policyholder to the insurance company. All other aspects of the insurance enterprise—the process by which the insurance company lays off risk in reinsurance markets, for example—would be outside of the definition. This interpretation is not inherently implausible: the passing of risk from insured to insurer is certainly at the core of the insurance enterprise, and concerted activity by the fire insurance industry with respect to premium rates in the core insurance contract was the conduct that triggered the prosecutions in *United States v. South-Eastern Underwriters Ass'n*.²⁴

A somewhat broader reading might include within "the business of insurance" all activities regularly conducted by those firms which have as their principal purpose and effect the passage of risk from one party to another. This interpretation, which looks at the basic economic function of insurance, would encompass activities such as reinsurance or annuities, if those dealings have the purpose and effect of passing risk.²⁵

An even more expansive interpretation might include not only transactions which have the principal purpose and effect of transferring risk, but also transactions which are directly related to the function of transferring risk. The relations between an insurance company and its agents, for example, do not usually involve the transfer of risk as their principal feature. Yet without agents, insurance which does perform the function of transferring risk could not be sold. Thus, agency contracts, together with a variety of other transactions by insurance companies, would fall within the category of transactions directly related to the function of transferring risk.

The broadest interpretation of the term "the business of insurance" would include all activities generally and traditionally engaged in by insurance companies. This would include, for example, investment functions such as the making of loans and the purchase of securities. It would also include all sorts of other functions necessary or convenient to the activities of a specialized risk bearer.

(1990).

²⁴ 322 U.S. 533 (1944) (criminal prosecution under federal antitrust laws against fire insurance companies that had allegedly fixed prices through participation in joint underwriting association).

²⁵ The passage of risk would have to be the *principal* reason for the transaction, since virtually all commercial transactions of any complexity involve some allocation of risks between the parties, and the term "the business of insurance" could not possibly cover all transactions in which some risk is transferred without sweeping virtually all of commerce within the scope of the McCarran-Ferguson Act. Ordinary commercial transactions in which some risk is transferred may have an insurance feature, but they are not part of "the business of insurance."

The scope of state and federal regulatory power hinges on the interpretation of this key phrase; accordingly, one might expect the caselaw to be clear and well-developed. Yet the cases provide no conclusive answer as to which interpretation, if any, correctly defines the scope of "the business of insurance." As a rough rule of thumb, it appears that the meaning of the phrase varies depending upon whether the case involves antitrust or other regulatory matters.

In particular, the courts in *antitrust* cases have interpreted "the business of insurance" narrowly, in accordance with the general rule disfavoring expansive interpretations of exemptions to the federal antitrust laws.²⁶ As such, the current test in antitrust cases lies somewhere in between the first two interpretations outlined above, and considers whether the practice asserted to be exempt from federal antitrust scrutiny (1) spreads risk for the policyholder, (2) is part of a contract of insurance, or (3) is exclusively limited to insurance industry participants.

The first and most important factor is "whether [a particular] practice has the effect of transferring or spreading a policyholder's risk."²⁷ This factor reflects the Supreme Court's view of the core function of insurance: spreading risk, and not including other things such as offering investment or management consulting services. Thus, in *Union Labor Life Insurance Co. v. Pireno*,²⁸ the Court held that a peer review practice for determining reasonableness of chiropractic rates did not constitute the business of insurance, in part because the practice was unconnected with the spreading and underwriting of policyholder risk. Similarly, in *Group Life & Health Insurance Co. v. Royal Drug Co.*,²⁹ the Court held that agreements between an insurer and participating pharmacies, under which the pharmacies supplied prescription drugs to policyholders at cost plus two dollars, did not constitute the business of insurance because the agreements did not spread risk, but merely passed cost savings on to policyholders and enhanced insurance company profits.³⁰

Courts also look to "whether the practice is an integral part of the policy relationship between the insurer and the insured"³¹ in evaluating whether a particular activity constitutes "the business of insurance" for purposes of the antitrust exemption. The rationale for this factor is that the "relationship between insurer and insured, the type of policy which

²⁶ See, e.g., *Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119, 129 (1982) (noting the Court's restraint in granting such exemptions). See generally Spencer Kimball & Barbara Heaney, *Emasculation of the McCarran-Ferguson Act: A Study in Judicial Activism*, 1985 Utah L. Rev. 1.

²⁷ *Pireno*, 458 U.S. at 129.

²⁸ 458 U.S. 119 (1982).

²⁹ 440 U.S. 205 (1979).

³⁰ *Id.* at 213-14.

³¹ *Pireno*, 458 U.S. at 126.

could be issued, its reliability, interpretation, and enforcement . . . were the core of the 'business of insurance.'"³² Accordingly, the Court in *Pireno* held that peer review procedures were not part of "the business of insurance," partly because they were not an "integral part of the policy relationship between insurer and insured."³³

Finally, courts in such cases also consider "whether the practice is limited to entities within the insurance industry."³⁴ This criterion is drawn from the history of the McCarran-Ferguson Act, which, according to the Supreme Court, was premised largely on the "widespread view that it [was] very difficult to underwrite risks in an informed and responsible way without intra-industry cooperation."³⁵ In practice, this factor has contributed to a narrow reading of "the business of insurance" in antitrust cases. For instance, in *Royal Drug Co.*, the Court concluded that agreements between an insurance company and participating pharmacies, which limited the prices charged for prescription drugs, were not part of "the business of insurance," in part because the agreements involved "the mass purchase of goods and services from entities outside the insurance industry"³⁶

The prevailing approach to defining "the business of insurance" for antitrust purposes thus appears at first glance to offer a fairly sensible resolution. However, the utility of a multifactor analysis obviously suffers dramatically if and when the relevant factors point in different directions. As such, the test provides no method for weighting the different factors, and it is not immediately evident which factor should be considered most important in the event they conflict. Accordingly, because the current three-factor test is unnecessarily complicated as a means for determining the scope of "the business of insurance" for antitrust purposes, we suggest that courts move to a simpler test, which would define "the business of insurance" for antitrust purposes as only the process of intra-industry cooperation for the purpose of sharing information and establishing uniform rates and policy forms.³⁷ This interpretation exempts from federal antitrust scrutiny the practices that the McCarran-Ferguson

³² *Royal Drug Co.*, 440 U.S. at 215-16.

³³ *Pireno*, 458 U.S. at 131.

³⁴ *Id.* at 129.

³⁵ *Id.* (quoting *Royal Drug Co.*, 440 U.S. at 221).

³⁶ 440 U.S. at 224.

³⁷ For recent decisions in which this type of conduct was found to be central to "the business of insurance," see, e.g., *In re Workers' Comp. Ins. Antitrust Litig.*, 867 F.2d 1552, 1556 (8th Cir.) ("Although a price fixing agreement may maximize profit, it is axiomatic that the fixing of rates is central to transferring and spreading the insurance risk."), cert. denied, 492 U.S. 920 (1989); *Proctor v. State Farm Mut. Auto. Ins. Co.*, 675 F.2d 308 (D.C. Cir.) (holding that horizontal agreement among five insurance companies as to rates paid to repair shop did not violate antitrust laws even though agreement was proven to have artificially depressed price of repair work), cert. denied, 459 U.S. 839 (1982).

Act was intended to insulate, and is consistent with the Supreme Court's renewed focus on intra-industry cooperation and the transfer of risk from policyholder to insurer through rates and policy provisions.

Thus far we have discussed "the business of insurance" as it applies to the antitrust exemption. It is evident, however, that the interpretation of the phrase in other regulatory settings is not necessarily the same.³⁸ As a functional matter, the courts are adjusting the boundaries between state and federal regulatory programs as they define the phrase "the business of insurance." Accordingly, the task of statutory construction properly takes into account not only the policies underlying the McCarran-Ferguson Act, but also those policies undergirding the other potentially applicable federal regulatory schemes. As such, the interpretation given to the phrase "the business of insurance" varies depending on the regulatory context in which the case arises.

For instance, in *Securities and Exchange Commission v. Variable Annuity Life Insurance Co.*,³⁹ the Supreme Court considered whether variable annuity contracts⁴⁰ offered by insurance companies were within the scope of "the business of insurance" and therefore exempt from the ambit of the federal securities laws. In concluding that variable annuity policies are not part of the business of insurance, Justice Douglas explained for the Court that

the concept of "insurance" involves some investment risk-taking on the part of the company. The risk of mortality, assumed here, gives these variable annuities an aspect of insurance. Yet it is apparent, not real; superficial, not substantial. In hard reality the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense. It is no answer to say that the risk of declining returns in times of depression is the reciprocal of the fixed-dollar annuitant's risk of loss of purchasing power when prices are high and gain of purchasing power when they are low. We deal with a more conventional concept of risk-bearing when we speak of "insurance." For in common understanding "insurance" involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts.⁴¹

It is easy to fault the reasoning of *Variable Annuity*, since Justice

³⁸ See *United States Dep't of the Treasury v. Fabe*, 113 S. Ct. 2202, 2209 (1993) (scope of general regulatory exemption for laws enacted for purpose of regulating business of insurance is broader than scope of analogous antitrust exemption).

³⁹ 359 U.S. 65 (1959).

⁴⁰ A variable annuity contract—unlike the fixed annuity contract traditionally offered by insurance companies—ties the benefits received by the policyholder to the success of the company's investment policy. However, in other respects, the variable annuity contract resembles traditional fixed annuities in that the company assumes mortality risk: payments are determined based on standard actuarial life expectancy tables, with the insurance company taking the risk that a customer will live longer than expected.

⁴¹ *Variable Annuity*, 359 U.S. at 71.

Douglas posited that because variable annuity policies assume only mortality risk, not investment risk, they do not assume "true risk" in the insurance sense.⁴² The standard fixed annuity, which the Court presumed did satisfy this test, also assigns investment risk to the customer: it protects the customer in the event that prices go down, but the customer bears all the risk of subsequent price increases. Yet despite these analytical shortcomings, the holding in *Variable Annuity* can be justified on policy grounds, because it represents a sound adjustment of the two underlying statutory schemes: it does not prohibit insurance companies from offering variable annuities, but simply subjects the offering and sale of variable annuities to the federal securities laws. This social policy, more than any abstract reasoning about the nature of "insurance," explains the result in the case.⁴³

A second reason why the interpretation of the phrase "the business of insurance" is different in general regulatory contexts than in the anti-trust context is that the purposes underlying the McCarran-Ferguson Act's regulatory exemption were different in that setting. As noted above, the Act's general exemption for "the business of insurance" was intended to ensure that state regulation and taxation of insurance could continue in the aftermath of the Supreme Court's declaration in *South-Eastern Underwriters* that insurance was commerce.⁴⁴ As such, activities protected by the phrase "the business of insurance" in the general regulatory context will be those related to states' tax and general regulatory powers.

It is clear, for example, that "the business of insurance" in the general regulatory context encompasses advertising of insurance policies, even though no risk is passed through advertisement.⁴⁵ It also extends to a broad range of activities for which an insurance company or agent would need to obtain a license under state law.⁴⁶ In addition, it includes insurance company activity which is subject to state safety and soundness regulation, and thus appears to encompass matters such as capital structure, investment portfolio choice, policy coverage, mergers, and con-

⁴² Id. at 71-73.

⁴³ For other cases which opt for federal law when adjusting the boundaries between state insurance regulation and federal securities regulation, see *SEC v. National Sec. Inc.*, 393 U.S. 453, 465-69 (1969) (applying federal insider trading laws to alleged misrepresentations incident to proposed merger of insurance firm, even though state insurance authority had affirmed the merger as being fair and not contrary to law); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 210-12 (1967) (applying Securities Act of 1933 to annuity contract offered by insurance company).

⁴⁴ See *South-Eastern Underwriters*, 322 U.S. at 553.

⁴⁵ See *FTC v. National Casualty Co.*, 357 U.S. 560 (1958) (per curiam).

⁴⁶ Cf. *Robertson v. California*, 328 U.S. 440 (1946) (applying pre-McCarran-Ferguson Act law).

solidations. Thus, despite the Supreme Court's admonition that the McCarran-Ferguson Act does "not purport to make the States supreme in regulating all the activities of insurance *companies*,"⁴⁷ the fact remains that the regulatory exemption for "the business of insurance" has been interpreted significantly more broadly than the corresponding antitrust exemption.

In the recent case of *United States Department of the Treasury v. Fabe*,⁴⁸ the Court provided the most explicit instruction to date on the scope of the general regulatory exemption. The broad category of laws enacted "for the purpose of regulating the business of insurance" consist, according to the Court, of laws that possess the "end, intention or aim" of "adjusting, managing, or controlling the business of insurance."⁴⁹ This category encompasses more than the business of insurance itself; it also includes the "actual performance of an insurance contract."⁵⁰ In *Fabe*, the Court concluded that a state statute giving priority in bankruptcy to policyholders prevailed over the federal bankruptcy priority statute that would have applied in the absence of the McCarran-Ferguson Act.⁵¹

Some additional light on the scope of the general regulatory exemption is provided by the only other Supreme Court case to address the issue, *Securities and Exchange Commission v. National Securities, Inc.*⁵² The Court in *National Securities* provided the following examples of activities which fall within the scope of the exemption: "[t]he relationship between insurer and insured, the type of policy which could be issued, its reliability, interpretation and enforcement," together with "other activities of insurance companies [that] relate to their status as reliable insurers."⁵³ Taken together, *Fabe* and *National Securities* provide adequate guidance as to the meaning of the general regulatory exemption. Accordingly, a new test does not appear warranted at this time.

B. Federal Regulation of "The Business of Insurance"

Even where a given activity falls within "the business of insurance" under the McCarran-Ferguson Act, federal regulation still may be applicable if (1) the state has failed to regulate the activity in question in a sufficiently direct or immediate way; (2) Congress has explicitly overrid-

⁴⁷ *National Sec.*, 393 U.S. at 459 (emphasis added).

⁴⁸ 113 S. Ct. 2202 (1993).

⁴⁹ *Id.* at 2210 (quoting Black's Law Dictionary 1236, 1286 (6th ed. 1990)).

⁵⁰ *Id.*

⁵¹ *Id.* at 2204. However, the Court also held that the McCarran-Ferguson Act was not so far reaching as to protect creditors other than the policyholders from federal preemption. *Id.* at 2212.

⁵² 393 U.S. 453 (1969).

⁵³ *Id.* at 460.

den state law in the applicable federal statute; or (3) the purported exercise of state regulatory authority violates the federal Constitution. The following Sections discuss how each of these situations affects the emerging pattern of regulatory federalism under the Act.

1. *The Federal Role in the Absence of State Regulation*

As noted above, the McCarran-Ferguson Act does not absolutely bar the federal government from regulating the business of insurance. In the antitrust setting, it provides instead that the federal antitrust laws apply to the business of insurance “*to the extent that such business is not regulated by State Law.*”⁵⁴ In the general regulatory setting, the statute states that “*regulation or taxation*” of “the business of insurance” is to be left to the states in the absence of clear and specific indication that federal legislation is intended to displace state law.⁵⁵ Accordingly, in the absence of some form of action by the states, federal law applies, notwithstanding the McCarran-Ferguson Act.

This allowance for federal regulation in the absence of state action could be interpreted in a variety of ways. The narrowest interpretation would read the reference to state regulation to mean only that federal laws would not apply if a state affirmatively mandated the conduct in question. A second, slightly broader reading of the statute would find federal regulation excluded only if the state adopted regulation at least as stringent as that applicable at the federal level. Under this reading, if a state adopted regulation less stringent than the federal law, then it would not displace the federal law. A third possible reading, less hospitable to federal enforcement, would displace federal law even where state regulation is less stringent than the otherwise applicable federal law, so long as the state regulation concerns the conduct which allegedly violates federal law and seeks to achieve objectives broadly consistent with federal policy. This broadest interpretation would allow the state to displace federal regulation by engaging in *any* regulation of the business of insurance, even if the state’s regulation had a different purpose than the federal regulation, and even if the state regulation were less stringent or covered different conduct than the otherwise applicable federal law.

As in the case of defining “the business of insurance,” the nature and quantity of state activity required to trigger the antitrust exemption may be different than that required to trigger the general regulatory exemption. The specific language of the statute supports distinguishing between the antitrust and general regulatory contexts. Because state “regulation” and “taxation” oust general federal laws in the absence of

⁵⁴ 15 U.S.C. § 1012(b) (1988) (emphasis added).

⁵⁵ *Id.* §§ 1011, 1012(a) (emphasis added).

specific congressional override, but federal antitrust law is displaced only "to the extent that" the states have not regulated, the exemption should be interpreted more narrowly in the antitrust context than in the general regulatory context. This situation-specific theory of the degree of state activity required to oust federal regulation appears to have been borne out by the caselaw.

a. The Antitrust Exemption. In the antitrust setting, courts have tended to favor the view that federal antitrust laws are displaced when state law regulates the same conduct and serves objectives broadly consistent with federal antitrust law. State antitrust laws are an obvious example of state legislation which might displace federal antitrust law, and the effects of such laws have become more pronounced in recent years as an increasing number of states have abandoned their antitrust exemptions for insurance companies.⁵⁶ The few cases that have examined the issue of whether state antitrust laws displace federal law generally conclude that such regulation must cover the same conduct and be at least as stringent as the federal regulation in order to trigger the bar of the McCarran-Ferguson Act.⁵⁷

A second, less obvious type of state regulation which might displace federal antitrust law is regulation relating to the substantive conduct of insurance companies within the jurisdiction. For instance, if a state affirmatively has regulated rate setting by insurance companies which operate within its boundaries, private cooperation in determining and setting rates should not be subject to federal antitrust scrutiny. It is not entirely clear from the cases, however, *how much* state involvement in rate setting is enough to displace federal antitrust scrutiny.

Nevertheless, some educated guesses can be made about the existing regimes of state rate regulation. The clearest case for the antitrust exemption is direct, plenary state rate regulation which affirmatively mandates rates in some product lines.⁵⁸ This type of regulation is currently

⁵⁶ For example, Texas and California recently have repealed the industry's exemptions from state antitrust laws, and campaigns to repeal state exemptions have occurred in Massachusetts, Rhode Island, and other states. See Neil McGhee, *Antitrust Law Exemption Challenged in Mass., R.I., Nat'l Underwriter* (Life & Health/Fin. Serv. Ed.), Apr. 1, 1991, at 23.

⁵⁷ For instance, in *United States v. Chicago Title & Trust Co.*, 242 F. Supp. 56 (N.D. Ill. 1965), a federal antitrust challenge to allegedly anticompetitive interstate acquisitions by a title insurance firm, the court rejected the argument that the state antitrust law displaced federal law under the McCarran-Ferguson Act. The court noted that the state did not have on the books "a provision precisely comparable to [§ 7 of the Clayton Act] proscribing acquisition of stock of another corporation. It is not sufficient that a state have legislated on other . . . antitrust matters." *Id.* at 60.

⁵⁸ A rule limited to state-mandated rates would be so narrow as not to go beyond the state action antitrust exemption. See text accompanying notes 178-92 *infra* (explaining state action exemption); see also *Parker v. Brown*, 317 U.S. 341, 350-51 (1943) (holding marketing pro-

in effect in Massachusetts.⁵⁹ States which require rates to be filed with the state insurance commissioner and affirmatively approved before use also probably “regulate” rates sufficiently to displace federal antitrust laws (at least if the approval serves as a meaningful constraint).

The argument for displacing federal law is weaker in the case of states that permit insurance companies to charge rates without prior state approval, subject to the requirement that the rates be filed with the state insurance commissioner either before the rates are charged or soon after the policies are offered at the new rates. Some states, notably Illinois, permit relatively free market setting of rates.⁶⁰ In such states, rates are not required to remain within a certain band of a target rate. Nor are companies normally required to comply with any filing provisions. However, the insurance commissioners in such states typically retain the authority to intervene to interdict rates found to be discriminatory, excessive, or inadequate, or, in some states, representative of unfair methods of competition.⁶¹

This final approach to rate regulation is more problematic with respect to the displacement of federal law than the previous alternatives. Arguably, if rates are to be set by market forces without substantial state oversight, then the state no longer “regulates” this part of the business of insurance, and price-fixing by insurance companies within the state should thereafter be subject to federal antitrust scrutiny. These considerations have lead some observers to conclude that the repeal of rating laws automatically subjects state insurance markets to federal antitrust regulation.⁶² On the other hand, if a state, in deregulating rates, has indicated an affirmative intent not to allow federal antitrust scrutiny—or if the state has affirmatively indicated an intent to leave the McCarran-Ferguson Act exemption in place despite the deregulation—then the argument for federal intervention is weaker than if the state affirmatively has consented to the application of federal antitrust law. As yet, the applicability of the McCarran-Ferguson Act to state rate deregulation has not been resolved definitively.⁶³

gram adopted to regulate handling, disposition, and price of raisins produced within State of California did not fall within federal antitrust laws).

⁵⁹ See, e.g., Mass. Ann. Laws ch. 175A, § 5A (Law. Co-op. 1987) (authorizing commissioner to set rates for medical malpractice insurance); id. ch. 175, § 113B (authorizing commissioner to set rates for motor vehicle liability policies).

⁶⁰ See Ruth Gastel, *Rate Regulation*, Ins. Issues Update (Insurance Info. Inst., New York, N.Y.), Aug. 1993, at 8.

⁶¹ See id.

⁶² See, e.g., Zack Stamp, *A Modest Proposal: Repeal of State Rating Laws*, Best's Rev. (Property/Casualty Ins. Ed.), Jan. 1991, at 45 (“Repealing the rating laws would . . . subject insurance pricing to federal antitrust laws.”).

⁶³ For instance, in one recent case, *In re Workers' Compensation Ins. Antitrust Litig.*, 867 F.2d 1552 (8th Cir.), cert. denied, 492 U.S. 920 (1989), Minnesota had partially deregulated

b. *The Regulatory Exemption.* The caselaw in the general regulatory area tends to cluster around the broadest reading of the degree of state regulation required to displace federal regulation.⁶⁴ In particular, state regulation of the business of insurance is considered to oust federal regulation when the state has adopted effective regulations specifically relating to the subject matter addressed by the federal regulatory scheme (whether or not the state law is as stringent as federal law). Federal regulation also is considered precluded when the state has regulated the business so comprehensively as to occupy the field of insurance regulation, even if the state does not have a specific regulation directed to the matter which the federal government is attempting to control.

For instance, in *Federal Trade Commission v. National Casualty Co.*,⁶⁵ the Federal Trade Commission (FTC) sought to apply its deceptive advertising rules against insurance companies acting within the boundaries of states which proscribed unfair insurance advertising and enforced those regulations through administrative supervision. The FTC argued that such legislation did not displace federal authority because it was too vague and had not been reflected in "administrative elaboration of these standards and application in individual cases."⁶⁶ As such, the FTC urged the Supreme Court to determine that although the states had legislated, they had not "regulated" as required under the McCarran-Ferguson Act.⁶⁷ Ultimately, the Court was unpersuaded, announcing in a conclusory per curiam decision that the state legislation was sufficient to displace federal regulation.⁶⁸

Subsequent lower court cases have read *National Casualty* as establishing a broad scope for the general regulatory exemption. It is not nec-

rates by permitting insurers to write policies at "rates that are lower than the rates approved by the commissioner provided the rates are not unfairly discriminatory." *Id.* at 1557. Under Minnesota's regulatory system, the state insurance commissioner still retained the power to prohibit unfair methods of competition or unfair or deceptive practices. See *id.* The Eighth Circuit held that the partial rate deregulation had not lifted the McCarran-Ferguson Act bar to federal antitrust scrutiny: although the state had "determined to promote price competition by leaving to the insurers' competitive judgment the setting of workers' compensation insurance rates below the allowable maximum," this policy "did not repeal the Commissioner's supervisory authority over rate setting practices." *Id.* at 1558.

The court went on, however, to find that the plaintiffs had introduced sufficient evidence in the trial court to trigger the boycott exception to the McCarran-Ferguson Act. *Id.* at 1561. The parties settled for \$50 million in January 1991, a resolution that received widespread notice in the insurance press. See, e.g., Colleen Mulcahy, *WC Insurers Settle Antitrust Suit*, *Nat'l Underwriter*, Jan. 28, 1991, at 3.

⁶⁴ See text accompanying notes 65-73 *infra*.

⁶⁵ 357 U.S. 560 (1958).

⁶⁶ *Id.* at 564.

⁶⁷ See *id.* at 564. Reading between the lines, one can infer that the FTC's real objection was that these state regulatory schemes were not being vigorously enforced.

⁶⁸ See *id.*

essary, for example, that the state statute or regulation deal specifically with the practice in question; it is enough that the state "have a general regulatory scheme governing the conduct of the insurance business."⁶⁹ It is sufficient if the state regulatory scheme is "comprehensive and meaningfully administered."⁷⁰

Nevertheless, although the scope of state regulation is quite broad, state regulatory power will not displace competing federal regulation in a number of circumstances. For instance, the mere fact that the state has the *power* to regulate will not be sufficient to oust federal control if the state has not chosen to *exercise* that power. Even if the state's decision not to regulate reflects a deliberate state policy to leave a particular area of commerce to free market forces, the McCarran-Ferguson Act might not prevent the application of federal regulation to the field deliberately abandoned by state authorities.

Furthermore, while state regulations need not be as stringent, or as stringently enforced, as the competing federal law, they cannot be completely lacking in substance. The Court noted pointedly in *National Casualty* that the FTC "does not argue that the statutory provisions here under review were mere pretense."⁷¹ The clear implication was that if the state had attempted to displace federal regulation by pretextual legislation, the Court would have looked through the pretense and held the federal law to be applicable.

Finally, state regulation will not oust federal control of activities engaged in by insurance companies in other states. In *Federal Trade Commission v. Travelers Health Ass'n*,⁷² for example, the Supreme Court held that the McCarran-Ferguson Act did not prohibit the application of the Federal Trade Commission Act to allegedly false and deceptive statements made in other states by an insurance company, even though the company's domiciliary state purported to prohibit all deceptive acts and practices by a domiciliary company regardless of location.⁷³ As such, despite the rather loose requirements for state regulation in the general regulatory setting, some limits do exist.

⁶⁹ *McIlhenny v. American Title Ins. Co.*, 418 F. Supp. 364, 369 (E.D. Pa. 1976) (holding that practice of requiring new homebuyers to purchase mechanic's lien insurance was under state regulation even though no state statute or regulation dealt specifically with the challenged practice).

⁷⁰ *Schwartz v. Commonwealth Land Title Ins. Co.*, 374 F. Supp. 564, 567 (E.D. Pa. 1974).

⁷¹ *National Casualty*, 357 U.S. at 564.

⁷² 362 U.S. 293 (1960).

⁷³ *Id.* at 298-99.

2. *Other Statutory and Constitutional Limits on the State's Power to Regulate*

Even if a state has "regulated" the business of insurance consistently with the requirements of the McCarran-Ferguson Act, federal law still applies if Congress has clearly indicated an intent to preserve the federal law notwithstanding the McCarran-Ferguson Act.⁷⁴ In the Act itself, several federal laws expressly are preserved as applied to the business of insurance, including the National Labor Relations Act, the Fair Labor Standards Act, and the Merchant Marine Act.⁷⁵

Aside from these statutes, express federal legislation overriding the McCarran-Ferguson Act exemption is uncommon. In fact, Congress has sometimes gone beyond what is strictly necessary in the other direction by reiterating a regulatory exemption for the insurance industry in other federal statutes. For example, Congress provided in the Employment Retirement Income Security Act (ERISA)⁷⁶ that "nothing in this [statute] shall be construed to exempt or relieve any person from any law of any State which regulates insurance, banking, or securities."⁷⁷ As courts have recognized, the insurance exemption in ERISA is essentially a restatement of the McCarran-Ferguson Act's general regulatory exemption.⁷⁸ Thus, even if Congress had not adopted the ERISA provision, the McCarran-Ferguson Act probably would have ousted ERISA control over state-regulated insurance activities.

Congress also considered the intersection between state and federal regulatory authority in the Comprehensive Environmental Response Compensation and Liability Act (CERCLA).⁷⁹ CERCLA expressly preempts state insurance laws which restrict the formation of certain risk-retention pools or purchasing groups,⁸⁰ but provides that "nothing in this subchapter shall be construed to affect either the tort law or the law governing the interpretation of insurance contracts of any state."⁸¹ As such, CERCLA generally retains the McCarran-Ferguson Act exemption outside the narrow setting of risk-retention pools.

Thus far, we have considered statutory limitations on the regulatory power of states under the McCarran-Ferguson Act. A number of *constitutional* limits on the states' power to regulate the conduct of insurance

⁷⁴ See 15 U.S.C. § 1012(b) (1988).

⁷⁵ See *id.* § 1014.

⁷⁶ 29 U.S.C. §§ 1001-1461 (1988 & Supp. II 1990).

⁷⁷ 29 U.S.C. § 1144(b)(2)(A) (1988).

⁷⁸ The ERISA exemption is interpreted in *pari materia* with the McCarran-Ferguson Act. See, e.g., *Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 41, 48-51 (1987) (interpreting ERISA "savings clause" by reference to factors which define "the business of insurance" under the Act).

⁷⁹ 42 U.S.C. §§ 9601-9675 (1988 & Supp. II 1990).

⁸⁰ See 42 U.S.C. §§ 9673-9675 (1988).

⁸¹ 42 U.S.C. § 9672(a) (Supp. 1992).

companies also have been articulated over the years.⁸²

To take the most obvious example, a state could not engage in racial discrimination through its insurance regulation, at least not unless the discrimination was supported by a compelling state interest. Nor could a state interpose regulation without giving the regulated party such rights to procedural due process as might be required under the federal Constitution. For the most part, however, these explicit protections for individual liberty are obvious and have not generated extensive litigation.

More problematic is the constitutional question of the geographic or jurisdictional reach of state regulatory power—its legislative jurisdiction. Because the insurance business is effectively nationwide in scope, one state's efforts to regulate that business often generate ripple effects in other states. This problem is particularly pronounced in the case of insurance, since the insurance contract itself is intangible, and it is often impossible to locate any defined "situs" for the contract rights in question.⁸³ In addition, the sheer weight of state insurance regulation suggests that this field should be the single most fertile breeding ground for cases involving principles of legislative jurisdiction.

Legislative jurisdiction cases focus on the power of a state under the federal Constitution to apply its law to transactions or relationships which may involve occurrences, parties, or rights located or arising in foreign jurisdictions. The leading early precedent in this area is *Allgeyer v. Louisiana*,⁸⁴ involving an action by the State of Louisiana against a Louisiana firm which obtained a policy of marine insurance which did not comply with a Louisiana law regulating the marine insurance business.⁸⁵ The insurance contract had been obtained from a New York insurance company and had been consummated in New York; the only acts which occurred in Louisiana were the mailing of a letter and trans-

⁸² Today, it is clear that states enjoy broad substantive powers to regulate the business of insurance within their borders, subject however to constitutional protections for personal liberties. The scope of state regulatory authority in this regard was more or less definitively established even during the heyday of the *Lochner* Era. Even then, the Court upheld broad state authority over the business of insurance as it was striking down a variety of other state attempts to regulate business. See, e.g., *La Tourette v. McMaster*, 248 U.S. 465 (1919) (upholding state regulatory power over insurance brokers); *German Alliance Ins. Co. v. Lewis*, 233 U.S. 389 (1914) (upholding Kansas rate regulation for insurance firms). Since that time, insurance has continued to be viewed as a business "affected with a vast public interest." *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408, 415-16 (1946) (citations omitted). The justification for highly rigorous state regulation is thus beyond serious question under current constitutional dogma.

⁸³ The parties to the insurance contract may be domiciliaries of different states. In addition, the policy itself may have been negotiated across state or international lines, and subsequently may be assigned to parties in still other jurisdictions. Furthermore, because the insured party or property is frequently mobile, the loss may occur in yet another jurisdiction.

⁸⁴ 165 U.S. 578 (1897).

⁸⁵ See *id.* at 579.

mission of premiums by the insured to the insurance company.⁸⁶

Given these minimal contacts between Louisiana and the transaction, the Supreme Court held that the state's law could not be applied consistently with the requirements of the due process clause of the fourteenth amendment.⁸⁷ A citizen of a state, said the Court, has "a right to contract outside of the State for insurance on his property—a right of which state legislation cannot deprive him."⁸⁸ This line of reasoning, which focuses solely on the right of a citizen to engage in contracts under the due process clause, would appear to invalidate regulation of intra-state transactions as much as interstate transactions if taken literally, yet the power of states to regulate insurance contracts *within* their borders had been recognized by the Court in an earlier case.⁸⁹ The Court resolved this problem by *ipse dixit*, namely:

[I]t may be conceded that [the] right to contract in relation to persons or property or to do business within the jurisdiction of the State may be regulated and sometimes prohibited when the contracts or business conflict with the policy of the State as contained in its statutes, yet the power does not and cannot extend to prohibiting a citizen from making contracts of the nature involved in this case outside of the limits and jurisdiction of the State, and which are also to be performed outside of such jurisdiction.⁹⁰

Later courts applied *Allgeyer* expansively to limit a state's authority to regulate insurance transactions in other states. In *St. Louis Cotton Compress Co. v. Arkansas*,⁹¹ the Court considered the legality of an Arkansas statute which taxed insurance premiums paid by out-of-state property owners to out-of-state insurance companies, when the property insured was located in Arkansas.⁹² The Supreme Court, per Justice Holmes, had little difficulty invalidating the statute on the authority of

⁸⁶ See *id.* at 580-81.

⁸⁷ See *id.* at 589. The case is chiefly remembered today for its eloquent, if subsequently repudiated, description of the activities falling within the realm of protected "liberty" under the due process clause. See *id.* (observing that due process clause protects "not only the right of the citizen to be free from the mere physical restraint of his person, as by incarceration, but . . . the right of the citizen to be free in the enjoyment of all his faculties; to be free to use them in all lawful ways; to live and work where he will; to earn his livelihood by any lawful calling; to pursue any livelihood or avocation, and for that purpose to enter into all contracts which may be proper, necessary and essential to his carrying out to a successful conclusion the purposes above mentioned").

⁸⁸ *Id.* at 591.

⁸⁹ See *Hooper v. California*, 155 U.S. 648 (1895) (upholding California statute making it a misdemeanor for a "person in [the] state" to procure insurance from a foreign insurance company which had not complied with California's bond-filing requirements), overruled on other grounds by *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944).

⁹⁰ *Allgeyer*, 165 U.S. at 591.

⁹¹ 260 U.S. 346 (1922).

⁹² See *id.* at 347.

Allgeyer, holding that “[a] State may regulate the activities of foreign corporations within the State but it cannot regulate or interfere with what they do outside.”⁹³ Rather than grounding its decision on broad notions of substantive due process, however, the Court opined that the parochial purpose underlying “the Arkansas tax manifests no less plainly than the Louisiana fine a purpose to discourage insuring in companies that do not pay tribute to the State.”⁹⁴

The developing principle that states could not regulate insurance transactions occurring outside their borders did not apply to situations in which the state asserting regulatory jurisdiction was the insurance company’s domiciliary state. Indeed, the courts always have recognized that domiciliary states have broad regulatory authority—broad enough in some cases to trump assertions of regulatory authority by the state in which policyholders reside. A classic early case is *Hartford Life Insurance Co. v. Ibs*.⁹⁵ The insured had failed to pay an assessment on a mutual life insurance plan, resulting in cancellation of the policy a few days before his death. The beneficiary sued for the death benefits under the policy in Minnesota state court, alleging that the assessment in question was illegal since the company improperly had accumulated large excess margins which enabled it to pay death benefits without assessment.⁹⁶ The insurer defended with a prior decree by the Supreme Court of its domiciliary state, Connecticut, which had affirmed the company’s right to levy the assessment.⁹⁷ On appeal, the Supreme Court held that the Connecticut decree was conclusive as to the rights of the policyholder, even though the policyholder had not been a party to the action, since the Connecticut courts had jurisdiction over “all questions relating to the internal management of the corporation.”⁹⁸

In *Home Insurance Co. v. Dick*,⁹⁹ the insured (Dick), a citizen of Texas, sued in Texas court on a contract of marine fire insurance issued in Mexico by a Mexican company to a resident of Mexico to cover losses in Mexican waters.¹⁰⁰ The insurer argued that Dick, an assignee of the policy, had failed to bring suit within one year as required by the contract.¹⁰¹ Dick successfully contended in state court that the time-bar provision was ineffective under a Texas law which purportedly invali-

⁹³ *Id.* at 349.

⁹⁴ *Id.*

⁹⁵ 237 U.S. 662 (1915).

⁹⁶ See *id.* at 673.

⁹⁷ See *id.* at 666.

⁹⁸ *Id.* at 671.

⁹⁹ 281 U.S. 397 (1930).

¹⁰⁰ See *id.* at 402.

¹⁰¹ See *id.* at 403-04.

dated contractual provisions cutting off certain rights of action.¹⁰² The Supreme Court reversed, holding that the Texas statute constitutionally could not be applied to bar the defense.¹⁰³

In defining the limits on a state's legislative jurisdiction, the Court explained that "[a] State may . . . prohibit and declare invalid the making of certain contracts within its borders. Ordinarily, it may prohibit performance within its borders, even of contracts validly made elsewhere, if they are required to be performed within the State and their performance would violate its laws."¹⁰⁴ The Court also noted that a state could prohibit the enjoyment by persons within its borders of rights acquired elsewhere which violate its laws or public policy, and in some cases could refuse to aid in the enforcement of such rights.¹⁰⁵ However, the Court's holding plainly implies that a state cannot apply its laws to invalidate a contract which has no connection with the forum other than the fact that it was assigned to a party residing in that state.

In *John Hancock Mutual Life Insurance Co. v. Yates*,¹⁰⁶ an insured obtained a life insurance policy in New York on the basis of material written misrepresentations about his health.¹⁰⁷ Soon after the policy was issued, the insured died. His beneficiary moved to Georgia and sued to recover the death benefit in the courts of that state. The insurance company set up the misrepresentation as a defense, but the beneficiary alleged that the insured truthfully had reported his medical condition to the agent, who had not recorded the information in the application.¹⁰⁸ This defense was good under Georgia law but not under New York law.¹⁰⁹ On appeal, the Supreme Court declared that the Georgia courts were required to respect the New York law under the full faith and credit clause of the Constitution.¹¹⁰ This outcome can be explained by the fact that all the legally significant events occurred in the State of New York.

In *Pacific Employers Insurance Co. v. Industrial Accident Commission*,¹¹¹ the Supreme Court held that the full faith and credit clause nevertheless permitted a state to apply its own law to determine the legal consequences of accidents occurring within the state, even if the accidents involved relationships previously established in other states.¹¹² In

¹⁰² See *id.* at 405.

¹⁰³ See *id.* at 407.

¹⁰⁴ *Id.*

¹⁰⁵ See *id.* at 410.

¹⁰⁶ 299 U.S. 178 (1936).

¹⁰⁷ See *id.* at 179.

¹⁰⁸ See *id.* at 179-80.

¹⁰⁹ See *id.* at 181.

¹¹⁰ See *id.* at 183.

¹¹¹ 306 U.S. 493 (1939).

¹¹² See *id.* at 503-04.

Pacific Employers, a Massachusetts employee of a Massachusetts employer was injured while detailed temporarily to the employer's California facility. The employee sued the employer's California workmen's compensation carrier and invoked the benefits of the California workmen's compensation statute, which were more generous than those available under the Massachusetts statute.¹¹³ The insurance company defended on the grounds that the California courts were required to give full faith and credit to the Massachusetts statute.¹¹⁴

In concluding that the California court could apply the California statute consistently with the full faith and credit clause, the Court observed that

in the case of statutes, the extra-state effect of which Congress has not prescribed, as it may under the constitutional provision, we think the conclusion is unavoidable that the full faith and credit clause does not require one state to substitute for its own statute, applicable to persons and events within it, the conflicting statute of another state, even though that statute is of controlling force in the courts of the state of its enactment with respect to the same persons and events.¹¹⁵

Because California had a valid legislative interest in the bodily safety and economic compensation of employees injured within its borders, the Court concluded that the California courts were free to apply California law to the occurrence, even though Massachusetts law would have applied if the events had taken place in that state.¹¹⁶ Moreover, the case appeared to establish the principle that the state in which the key events giving rise to the legal dispute occur always has legislative jurisdiction to apply its law in litigation in that state's courts.

In *Allstate Insurance Co. v. Hague*,¹¹⁷ the Court considered a benefits claim brought in Minnesota court, arising from a Wisconsin insurance policy which covered an accident that occurred in Wisconsin involving only Wisconsin residents.¹¹⁸ The Minnesota Supreme Court held that Minnesota law, which permitted a beneficiary to "stack" the uninsured motorist coverage clauses on separate automobiles to increase coverage limits, applied in the case.¹¹⁹

The U.S. Supreme Court affirmed in a plurality opinion. Declaring that the constitutional analysis was fundamentally the same under the due process clause and the full faith and credit clause¹²⁰—a point that

¹¹³ See id. at 497-98.

¹¹⁴ See id. at 499-500.

¹¹⁵ Id. at 502.

¹¹⁶ See id. at 503.

¹¹⁷ 449 U.S. 302 (1981).

¹¹⁸ See id. at 305-06.

¹¹⁹ *Hague v. Allstate Ins. Co.*, 289 N.W.2d 43, 49 (Minn. 1979).

¹²⁰ See *Allstate*, 449 U.S. at 308 & n.10.

had been in some doubt—the plurality stated that if the state whose law was being applied “has had no significant contact or significant aggregation of contacts, creating state interests, with the parties and the occurrence or transaction,” the application of that state’s law would be inconsistent with the Constitution.¹²¹ If, on the other hand, the state had sufficient contacts such that “choice of its law is neither arbitrary nor fundamentally unfair,”¹²² then the state constitutionally could apply its law.¹²³

In sum, while this line of cases does not establish any clear-cut rule for state legislative jurisdiction over the insurance business, it would appear that the states have considerable constitutional leeway in regulating insurance transactions with significant interstate contacts. The cases in which the Supreme Court has invalidated state legislative jurisdiction represent extreme situations, in which a state has extended its regulatory grasp to transactions which had only marginal contacts with that state. However, as long as there exist sufficient minimum contacts between the state and the transaction in question, the state constitutionally may apply its law. This is so even if one or more other states also possess legislative jurisdiction.

Our conclusion that the Constitution imposes only minor constraints on the extraterritorial application of state insurance regulation raises the question of why the states have not engaged in internecine regulatory war in an attempt by each to apply its law to the widest possible range of practices. Several factors could explain the surprisingly peaceful conditions in state insurance regulation, notwithstanding the potential for regulatory conflict which is built into the constitutional structure.

First, the states have a long history of working through organizations such as the National Association of Insurance Commissioners (NAIC) to devise regulations that accommodate the legitimate regulatory concerns of the different states involved. These multistate organizations have operated as effective checks against the states’ otherwise operative incentive

¹²¹ *Id.* at 308.

¹²² *Id.* at 313.

¹²³ *Id.* at 312-13. However, the decision in *Allstate*, despite its broad language, does not resolve completely the constitutional questions because it enjoyed the assent of only a plurality of the Court. Justice Stevens concurred only in the judgment, articulating as the relevant constitutional standard the proposition that “the [Full Faith and Credit] Clause should not invalidate a state court’s choice of forum law unless that choice threatens the federal interest in national unity by unjustifiably infringing upon the legitimate interests of another State.” *Id.* at 323 (Stevens, J., concurring in the result).

The three dissenting Justices (Powell, Burger, and Rehnquist) agreed with the plurality that a state’s application of its law should be invalidated “only when there are no significant contacts between the State and the litigation.” *Id.* at 332 (Powell, J., dissenting). In the view of the dissent, however, the contacts with Minnesota were so minimal as to fail even this “modest check on state power.” *Id.* at 332 (Powell, J., dissenting).

to apply their own laws to interstate transactions. Federalism also ensures that state insurance regulators will be aware that failure to devise workable strategies for interstate accommodation increases the risk of federal intervention.

A second reason for the lack of interstate regulatory war is that the insurance business is amenable to relatively straightforward allocations of jurisdictional responsibilities among state regulators. Simple administrative ease has lead states quite naturally to assign to the state of domicile the principal responsibility for solvency regulation, subject to the power of other states to bar out-of-state insurers from writing policies in the state if the out-of-state firm is considered to present unacceptable risks to policyholders in the state. Regulation of insurance policies can be roughly, but effectively, allocated on the basis of the location of the insured. Regulation of the relationship between agencies and insurance companies can be committed to the state in which the agency is located. Regulation of advertising and other trade practices can be undertaken by the state in which the advertising or trade practices take place. This allocation is not perfect by any means, and in many situations, especially in the case of commercial lines, may not identify unambiguously a primary regulator. For most purposes, however, these rules of thumb quite effectively determine which state should take the lead in regulating a particular transaction or practice.

Third, the McCarran-Ferguson Act *itself* has tended to inhibit regulatory conflict among the states. In *Federal Trade Commission v. Travelers Health Ass'n*,¹²⁴ the Supreme Court invalidated an attempt by an insurance company's domiciliary state to displace federal regulation of practices occurring in other states by adopting legislation purporting to regulate the activities of the domiciliary company in other states.¹²⁵ The Court stated that the "state regulation which Congress provided should operate to displace . . . federal law means regulation by the State in which the [practice] has its impact."¹²⁶ Thus, while the case did not directly address the constitutional constraints on state action, it discouraged vigorous attempts by states to export their laws because it suggested that such state laws would be ineffective to trump otherwise superseding federal regulations.

Although these rule-of-thumb allocations of state regulatory authority have proven remarkably stable and successful historically, there are some signs of potential breakdown in state cooperation in the area of antitrust regulation. California's Proposition 103¹²⁷ applied state anti-

¹²⁴ 362 U.S. 293 (1960).

¹²⁵ See *id.* at 297-98.

¹²⁶ *Id.* at 298-99.

¹²⁷ 1988 Cal. Legis. Serv. Prop. 103 (West).

trust rules to insurance companies—rules that California officials consider to be more stringent than the corresponding federal laws.¹²⁸ Moreover, California's attorney general has taken the position that "it does not matter where the [conduct creating liability] takes place. You cannot comply with California's antitrust laws by breaking them in another state or country. If the effects are felt in California, California law applies."¹²⁹ If Proposition 103 is enforced as strictly as these comments suggest, the result could be the exportation of California's stringent antitrust rules to regulate the conduct of insurance companies nationwide, on the theory that such conduct has "effects" in the California market. It remains to be seen whether the California initiative will disrupt the system of interstate cooperation in insurance company regulation.

*C. The Model of State Regulation Created by
the McCarran-Ferguson Act*

Having outlined the ways in which the Constitution and federal and state statutes allocate jurisdiction over the insurance industry as between the states and the federal government, we are now in a position to formulate a general theory about the dynamic structure of this system of regulatory federalism. In this Section we contrast three models of insurance regulation within a federal system: the state rate regulation model, the concerted withdrawal model, and the race-to-the-bottom model.

While this examination might appear somewhat removed from the concrete regulatory world explored above, the answers provided here are, in fact, vital in assessing whether the current roles of the federal and state governments under the McCarran-Ferguson Act need to be revamped. Indeed, whether specific proposals for reform currently under consideration would be desirable hinges on which of these models one believes best represents the scheme of regulatory federalism created by the McCarran-Ferguson Act.

The first regulatory model, the "state rate regulation" model, describes the likely consequences of state action which affirmatively sets rates for insurance products. It should go without saying that state insurance regulators have no foolproof means of determining the rates that would be set for insurance products by an efficient private market when they go about establishing rates—either by direct administrative control or by deference to industry rating bureaus. Because the market price that would prevail in the absence of rate regulation is impossible to determine, the administratively determined rates are very likely to be either

¹²⁸ See Joanne Wojcik, *California Antitrust Rules Anger Insurance Industry*, *Bus. Ins.*, May 21, 1990, at 3, 11.

¹²⁹ *Id.*

too high (i.e., above market-clearing rates), or too low (below market-clearing rates).

Consider first the scenario in which rates initially are set too low. If the initial rate set by the commission were below the point of reasonable profit, insurance firms would begin to withdraw coverage in the state.¹³⁰ These withdrawals would not be part of any conspiracy to elicit regulatory favors but simply would reflect the fact that the less efficient firms cannot operate at a profit under the applicable regulations. The withdrawals, in turn, would induce protests by policyholders and, eventually, provide a reason for the insurance commission to raise rates.

If, on the other hand, the rate initially set were too high, the natural corrective effect of withdrawals would not be present. No firms would leave the market. There are, to be sure, several natural checks to excessively high rates. Insurance firms are likely to engage in nonprice competition, thus dissipating some of the excess profits, and eventually high prices are likely to induce consumer complaints. In general, however, the dynamics of the market would appear to result in rates above market-clearing levels in situations where rates are set administratively.

The effect of all this is that in an environment of state rate setting, insurance rates will tend, on average, to rise above market-clearing levels. Because rates will tend to be higher than those that would prevail in an efficient market, consumers will have access to less insurance and will have to pay more for insurance when they get it. Insurance firms, on the other hand, will tend to earn above-market returns on their activities, although these rents will be somewhat dissipated by nonprice competition.

Different considerations apply if we posit the existence of aggressive, well-organized consumer interests in the state. These groups may be able to obtain rate rollbacks and even reductions of rates below market-clearing levels. The natural response of the less efficient firms in the industry then would be to withdraw from the state in order to avoid continued losses. Thus, if firms can withdraw without incurring additional losses, the impact of consumer groups is likely to be temporary: firms in the state's market may find some of their wealth expropriated, but in the long run the effect of withdrawals will be to drive rates back up to or beyond market-clearing levels.

Recent experience in several states, however, suggests a possible additional factor for consideration. If a state can impose a sufficiently high "exit fee" or tax on firms wishing to withdraw from the state, then the

¹³⁰ Withdrawals occur today; a prominent recent example is the decision by seven large companies to leave the Massachusetts automobile insurance market in order to escape that state's rate-setting system. See Henry Stimpson, *Massachusetts Mirage?*, 50 *Ins. Rev.* 36, 36 (1989).

withdrawal option may not be feasible even for a firm which is operating below its cost, if the present value of the losses associated with the tax exceed the present value of the losses associated with continued operation in the state. Recent pro-consumer statutes—such as California's Proposition 103 and the omnibus Texas statute—have included exit taxes of various sorts.¹³¹ If a state can effectively neutralize the withdrawal threat, it may be able to expropriate the wealth of shareholders—especially shareholders of out-of-state firms¹³²—for the benefit of policyholders in the state.

We believe that the state rate regulation model presents the most accurate picture of the dynamics of regulatory federalism in the insurance industry. It predicts that, aside from the matter of rates, the regulatory system is unlikely to display any systematic favoritism for insurers and against policyholders as a result either of systematic withdrawals or of interstate competition for charters. It further predicts that the business of insurance is likely to be conducted in a relatively economically efficient manner in states without rate regulation.

In states *with* rate regulation, however, the model predicts that rates will either equal or exceed market-clearing levels in most cases. How-

¹³¹ The Texas legislation, for example, requires insurers to file a withdrawal plan and obtain approval from the insurance commissioner before leaving the market, bars a firm from re-entering the state for five years after withdrawal from the market unless the commissioner approves an earlier reentry, and requires a substantial notice period before termination of agency agreements. See Jaclene Fayhee, *Texas Reforms Pass by Big Margin*, *Nat'l Underwriter*, June 3, 1991, at 1. The California law did not prohibit automobile insurers from exiting the market entirely, but did severely restrict the power of firms selectively to exit the market by canceling policies. See *Cal. Ins. Code* § 1861.03(c) (Deering 1992); *Calfarm Ins. Co. v. Deukmejian*, 771 P.2d 1247 (Cal. 1989).

¹³² One recent study documents significant negative stock price effects surrounding the time of the adoption of Proposition 103. See Roger M. Shelor & Mark L. Cross, *Insurance Firm Market Response to California Proposition 103 and the Effects of Firm Size*, 57 *J. Risk & Ins.* 682 (1990). When the data were disaggregated to distinguish between insurers with heavy California involvement and non-California insurers, however, the study found no significant impact for the in-state firms and large statistically significant negative responses for the out-of-state firms. While the authors of the study postulate that the effect reflects differences in firm size, an equally plausible explanation is that firms with heavy involvement in California are able to exercise political influence in order to receive relatively more favorable regulatory treatment than firms with only a small California presence.

The inference that Proposition 103 and similar programs might be used as instruments for in-state favoritism is reinforced by actual events. In California, for example, the current insurance commissioner has declared that income from investments outside of California will be included in the California rate base, thus subjecting out-of-state firms to the possibility of multiple counting on their out-of-state investment income. See Joanne Wojcik, *New Regulator Freezes Rates under Prop. 103*, *Bus. Ins.*, Jan. 14, 1991, at 1. In New Jersey, a measure adopted in March 1990 required automobile insurers to assume \$1.4 billion of the debt of the state's Joint Underwriting Association, see Gastel, *supra* note 60, at 11; the result was to expropriate the wealth of company shareholders located all across the country for the benefit of a class of New Jersey motorists.

ever, in states where two factors coalesce—active, organized, and enduring consumer political groups and significant exit fees on withdrawals—the result may well be the opposite, namely, sustained below-market rates.

We now turn to a competing model, the concerted withdrawal model. Under one scenario, a deterioration of regulatory standards could occur where insurance companies threaten to leave states en masse unless the states adopt regulations which help the insurance industry, but hurt consumers. Faced with this kind of threat, the states would capitulate to the insurance industry's demands on the theory that having some insurance available, even on inadequate terms, is better than having none at all. The result would be regulation that inadequately protects consumers and unjustifiably enriches insurance companies.

Contrary to the assumptions of the concerted withdrawal model, however, the industry's ability to implement this sort of concerted action under present conditions is very limited. If the insurance business in a state is profitable at the time of the threat to leave, the firms that leave will sacrifice these profits as well as their business goodwill by departing. Moreover, if the business is profitable some firms will not leave, knowing that the departure of competitors will leave a rich market for them to exploit. The low barriers to entry in insurance also suggest that start-up firms will be established quickly to pick up the market share that the existing firms have abandoned.

The scenario of an industry threat to leave for the purpose of extorting benefits at the expense of consumers accordingly is unrealistic unless the industry itself is highly organized for concerted action with effective sanctions against firms that refuse to cooperate. There is little evidence to suggest that an effective threat of group withdrawal could be organized today, except in unusual market settings, if the purpose were to extort benefits rather than to leave a market which had truly become unprofitable. As such, the concerted withdrawal model does not offer sufficient explanatory force as applied in the insurance regulation setting.

A third model of regulatory federalism in insurance markets, the race-to-the-bottom model, draws on an analogy to corporate law regulation. In the corporate context, the competition of states for corporate charters (and the tax revenues and other income that corporate charters bring in) has been said to stimulate a "race to the bottom" in which states vie with each other to offer the menu of regulations most desired by corporate managers, even though in doing so they permit managers to engage in egregious abuse of shareholder interests.¹³³ As applied in the

¹³³ The race-to-the-bottom theory is most prominently associated with Professor William Cary, see William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 53

insurance setting, states might compete to become the domiciles of insurance firms in order to obtain the resulting taxes, jobs, and other benefits; in order to attract insurance firms to their borders, they would therefore offer a regulatory regime which served the interests of insurance firms while harming those of policyholders.

Whatever its merits as a description of corporate law,¹³⁴ the race-to-the-bottom theory is not convincing as applied to insurance regulation. As an initial matter, the model neglects to consider the effect of policyholder choice in insurance markets. If an insurance firm domiciled in State A offers a product permitted under the law of State A which has features inimical to consumer welfare, that product is not likely to fare well in competition with more desirable products offered by other companies. Constrained by consumer choice, insurance companies are not likely to demand legal regimes which permit them to abuse consumer welfare. Even if such regulatory regimes exist, insurance companies are not likely to take advantage of them.

Moreover, with respect to policy terms, it is not possible for a firm to export costs to policyholders located in other states as it is possible, for example, for a corporation chartered in one state to export the costs of pro-management rules to shareholders located in other states. As described above, regulation of policy terms is similarly subject to the control of the state in which the insurance customer is located.¹³⁵ Thus, even if a firm's state of domicile allowed its insurance firms to engage in egregious or abusive practices toward policyholders, the state in which the policyholder is located is not likely to do so.

Exportation of costs theoretically is possible in the case of insurer solvency regulation, as opposed to regulation of policy rates and provisions, but insurance companies do not have a strong incentive to induce their domicile states to promulgate excessively lax solvency regulations. On the contrary, the larger, established insurance companies which hold political power in a given state are likely to prefer quite *stringent* solvency regulation. Stringent solvency regulation can operate as a barrier to entry for new competition. For example, if substantial capital is required to open a new insurance company in the state, fewer new companies will be formed. Additionally, the established firms in the industry are likely to prefer relatively stringent capital regulation in order to bolster the reputation of their domicile state as a reliable regulator of solvency. Such a reputation for the regulator redounds to the benefit of firms in the state by providing credible signals of their own solvency and

Yale L.J. 663 (1974).

¹³⁴ For our own contribution to this debate, see Jonathan R. Macey & Geoffrey P. Miller, Toward an Interest-Group Theory of Delaware Corporate Law, 65 Tex. L. Rev. 469 (1987).

¹³⁵ See notes 84-94 and accompanying text *supra*.

good business repute. As such, while it is true that some states might attempt to attract insurance company charters by offering lenient solvency regulation, the consequence would be to draw the worst-capitalized and most failure-prone firms, while driving well-capitalized firms away to other states. Moreover, other states would likely bar firms chartered in the low-regulation state from writing policies within their borders if such firms were deemed to present excessive insolvency risks.

The regulatory reach of the states over insurance markets¹³⁶ also suggests that each state will control the most important features of insurance transactions which occur within its borders. One practical impact of these overlapping regulatory regimes is that they likely remove any incentive for large firms to move to states with lenient, anticonsumer regulations. To realize economies of scale, large firms need to use the same forms, policies, and procedures in all the states in which they operate. Therefore, if one state is particularly stringent, the large firms might adjust their entire business operations to comply with the requirements applying in the single stringent state. There tends to be a one-way ratchet for large firms in the direction of complying with more stringent regulations. But according to the race-to-the-bottom theory, it is exactly these large firms which are likely to move their domiciles in order to take advantage of more lenient legal regimes. Smaller firms are not likely to do so because the transaction costs of moving exceed whatever benefits they could obtain from doing so. Accordingly, large insurance firms are not likely to demand particularly lenient legislation or to respond to state inducements to change domiciles in order to obtain favorable treatment.

Finally, in the case of insurance regulation, unlike general corporate regulation, there exists an elaborate mechanism for cooperation and communication among the state regulatory bodies. The practical necessity of state insurance solvency regulators to work together provides powerful disincentives to any state to initiate a competition in laxity. Such antisocial behavior likely would be met by retaliation from other state regulators, which could impose significant costs on any state regulator which sought to poach on other states' domains.

For all these reasons, the regulatory pattern in the insurance industry does not appear to be structured in such a way as to induce a race to the bottom. Not surprisingly, there appears to be very little movement of insurance firms away from their states of domicile, and firms—even the very largest firms—have usually remained in the states in which they were initially chartered. Moreover, no convincing evidence suggests that the states in which the largest insurance companies are domiciled—New

¹³⁶ See text accompanying notes 74-129 *supra* (describing jurisdictional reach of state regulation).

York, New Jersey, Illinois, Connecticut, Massachusetts, California, and others—have engaged in any sort of competition in laxity; on the contrary, these states appear to be among the more stringent insurance regulators nationwide.

In sum, the failings of both the concerted withdrawal and race-to-the-bottom models suggest that the state rate regulation model is the most appropriate description of the dynamic functioning of insurance markets within our system of regulatory federalism. The model predicts that, aside from the matter of rates, the regulatory system is unlikely to display any sustained favoritism for insurers and against policyholders as a result of either systematic withdrawals or interstate competition for charters. It further predicts that the business of insurance is likely to be conducted in a relatively economically efficient manner in states without rate regulation. In states with rate regulation, however, the model predicts that rates will either equal or exceed market-clearing levels in most cases. However, in states where two factors coalesce—active, organized, and enduring consumer political groups and significant exit fees on withdrawals—sustained, below-market rates may result.

II

RECONCEIVING THE FEDERAL ROLE UNDER THE McCARRAN-FERGUSON ACT

Because the state rate regulation model provides the best framework to evaluate the system of insurance regulation created by the McCarran-Ferguson Act, we can draw several tentative conclusions about the desirability of federal regulation in a number of specific settings. The analysis presented thus far suggests that federal regulation is not generally needed as a corrective to systematic anticonsumer bias in the existing structure of insurance regulation. The analysis here also suggests that state rate regulation should be abandoned. Moreover, we may infer that antitrust regulation should be administered so as to enhance the efficiency of market forces in setting insurance rates. Finally, the analysis implies that administrative rate setting is likely to result in systematically skewed results—rates that are either too high or, where consumer groups are powerful and exit fees are imposed, too low. This suggests that federal preemption might be useful in order to remove the unnecessary overlay of state rate regulation and to ensure that rates are set by market forces. In this Part, we examine the rationales behind the antitrust exemption, solvency regulation, and regulation in light of the model developed in Part I, concluding that the current regulatory regime is generally adequate but suggesting certain specific reforms.

A. *The Antitrust Exemption*

We now address the McCarran-Ferguson Act's antitrust exemption. It should be observed at the outset that the McCarran-Ferguson Act does not provide a safe harbor against scrutiny under *state* antitrust laws. Historically, many states have exempted the business of insurance from their own antitrust laws as well, so that the practical effect of the Act was to protect the industry against antitrust scrutiny of any sort. In recent years, however, states have begun to apply their own antitrust laws with greater vigor. As of year-end 1990, the insurance industry was, for practical purposes, subject to full antitrust scrutiny under state law in twenty-eight states.¹³⁷ Although merely being subject to a state's antitrust law does not necessarily mean that an insurance firm would be scrutinized as vigorously as it would if federal law applied, it is evident that state regulators are increasingly favoring the use of their own antitrust laws to control anticompetitive behavior by insurance firms.¹³⁸

The McCarran-Ferguson Act provides a partial exemption from federal antitrust law and in so doing stands in some tension with basic principles of competition that structure the vast majority of economic activities in the United States. As the Supreme Court has observed, the national policy favoring free competition and disfavoring cartels is "pervasive," "fundamental," and "essential to economic freedom."¹³⁹ Against the backdrop of such a fundamental policy, any exemption from the federal rule against private collusion in price setting must overcome a substantial burden of persuasion.

After examining the various rationales advanced to support the federal antitrust exemption, this Section looks at the scope of the exemption as applied by the courts. It then addresses the probable impact of applying federal antitrust scrutiny to the industry.

1. *Rationales for the Exemption*

a. Sharing Information. The most cogent argument for the antitrust exemption is that it facilitates the economically efficient sharing of information, and accordingly permits insurance companies to evaluate risk and price insurance accurately.¹⁴⁰ Industry rating bureaus thus are

¹³⁷ See Edward J. Muhl, A Ceasefire in the War of Words, *Best's Rev. (Property/Casualty Ed.)*, Dec. 1990, at 28.

¹³⁸ One potential political effect of this increased use of state antitrust laws may be the mitigation of the industry's traditional opposition to McCarran-Ferguson Act reform, on the theory that many of the benefits of the Act are already lost if the industry is subject to vigorous antitrust scrutiny under state law.

¹³⁹ *FTC v. Tico Title Ins. Co.*, 112 S. Ct. 2169, 2176 (1992).

¹⁴⁰ See Daniel J. McNamara, *Toward a New Environment*, *Best's Rev. (Property/Casualty Ed.)*, June 1990, at 53 ("One primary justification for these activities within our competitive

seen as serving the socially efficient goal of accurate pricing, and are not considered to have been designed to facilitate any sort of anticompetitive price fixing. Even where private rating bureaus have small anticompetitive effects, however, the social costs of the reduction in competition are presumed to be outweighed by the social efficiencies which rating bureaus make possible.

This argument starts with the observation that faulty pricing of insurance products causes harmful economic distortions and inefficiencies. If rates are set too low, the effect will be to subsidize activities by insureds, resulting in social costs of excessive activity levels. Excessively low rates, moreover, will cause insurance firms to be unprofitable, resulting in the departure of some firms from the industry and the under-provision of insurance by those that remain. Shortages will occur, and some parties will find themselves unable to obtain insurance at all. If rates are set too high, on the other hand, insurance firms will prosper, but policyholders will pay too much; thus socially desirable activities will be discouraged. Some customers will be unable to afford insurance at all, and will be forced either to abandon their activities or to self-insure under circumstances where an insurance contract could have been obtained if the product had been priced correctly. High rates would also reduce the incentive to operate efficiently that insurance firms otherwise would face in an unregulated pricing environment; accordingly, waste and inefficiency in the provision of insurance services will result.

Cooperation among insurance companies is necessary to achieve accurate pricing in the industry, especially for property/casualty lines. Overall, insurance premiums reflect the provider's evaluation of the probable costs of paying claims, as well as other costs of doing business and a reasonable provision for profit. But, in the case of property/casualty lines, the cost of claims payable in the future is difficult to assess at the time the policy is written, because both the probability of an event occurring, and the severity of the event if it does occur, are difficult to evaluate. Proper evaluation of risk requires extensive sampling of past occurrences of the events insured against, as well as analysis of the historical sample in order to predict losses in the future.

This sampling and analysis can only be accomplished, so the argument goes, through cooperative efforts among insurers. Cooperation thus serves two principal purposes. First, it makes historical loss data available in a sufficiently large sample to provide a high degree of statistical reliability in the analysis. In the absence of cooperation, each firm might hold its own historical loss data as a form of proprietary informa-

capitalistic system is that the pooling of data is necessary to determine adequate premiums and to achieve more equitable premiums by individual risk classification.").

tion, and it would be difficult for any insurance firm, except the very largest companies, to base loss predictions on a reliable sample of past experience.¹⁴¹ Second, cooperation achieves economies of scale because the sampling and analysis need only be done once, by an industry-wide rating bureau, rather than many times within individual firms. For both of these reasons, under this argument, cooperative rating bureaus are necessary to achieve accurate insurance pricing, at least in the property/casualty insurance business.

The strength of the economic argument for information sharing depends substantially on the types of information being shared. Historically, rating bureaus have provided three general types of information to firms in the industry: historical loss costs, prospective loss costs, and advisory rates. Of the three, *historical loss costs* clearly present the strongest case, particularly as respects historical loss data for property/casualty insurers.¹⁴²

The argument for sharing information within the industry is persuasive as applied to historical loss data for property/casualty insurers. It is true that property/casualty firms might obtain broadly based historical loss data even if they were barred from directly sharing data with competitors. An independent consulting firm, not in the insurance business, could purchase historical loss data from many firms, compile the data, and then sell it back to assist firms in their pricing decisions. The transaction costs associated with such a third-party arrangement might be high, however, and firms might not have confidence in the data or analysis provided by the consulting company. They also might not be sure that the data provided to the consulting company by their competitors are fully accurate. Problems such as these might make information-sharing arrangements within the industry itself the most efficient means of gathering and compiling historical loss data for property/casualty lines.

The economic justification for sharing historical loss data may also extend to *prospective loss costs*—the *analysis* of data after it has been compiled. Insurance rating bureaus offer not just historical cost data, but also prospective loss cost analysis that projects future costs. Although the details of prospective analysis may differ across rating bureaus,¹⁴³

¹⁴¹ See Francis Achampong, *The McCarran-Ferguson Act and the Limited Insurance Antitrust Exemption: An Indefensible Aberration?*, 15 Seton Hall Legis. J. 141, 155 (1991).

¹⁴² The argument is somewhat less plausible for life and health insurance firms, since mortality and morbidity statistics are widely available from a variety of public and private sources outside the insurance industry.

¹⁴³ There are two principal nationwide rating bureaus in the property/casualty area: the Insurance Services Office, Inc. (ISO), which serves most property/casualty lines, and the National Council on Compensation Insurance (NCCI), which serves workers' compensation lines. See notes 144-47 and accompanying text *infra* (discussing rating bureaus). A variety of smaller rating bureaus provide related services. See *id.*

there appear to be two key elements in most systems.

First, a rating bureau may attempt to take account of the fact that payments often are not made for years or even decades after the policies in question have expired. *Loss development analysis* measures changes in historical incurred losses resulting from late reported claims and changes in dollar values for claims already reported.¹⁴⁴ Loss development analysis utilizes new information to project future costs of claims on past policies. The argument for sharing information about future policy losses for claims on past policies is quite strong. Such information sharing avoids duplication of effort, and would not easily occur in the absence of collaborative activity because much of the data on which the loss development analysis is based is proprietary information in the control of individual companies. Accordingly, we believe that insurance companies should be able to engage in collaborative loss development analysis without incurring potential liability thereby under the federal antitrust laws.

Second, while loss development analysis is used to estimate what the ultimate losses will be for claims associated with *past* policies, *trend analysis* addresses the question of the losses associated with *future* policies.¹⁴⁵ Trend analysis takes account of significant economic or legal changes that are likely to affect losses on future policies, including the inflation rate, changes in the law, and increases or decreases in the frequency of claims. The effect of these changes is to make historical, developed loss costs an unreliable measure of losses on future policies. Trending is designed to correct for these distortions.

Although the argument for collaborative efforts in loss development analysis is strong, the argument is somewhat weaker in the case of trend analysis. There is usually no problem of proprietary information for many aspects of trending analysis; provided that the raw data are available, anyone can analyze them. For example, the inflation rate is readily available from a wide range of sources, and economic science has yet to develop a reliable technique for estimating the rate of future inflation. The argument for trending is considerably stronger with respect to categories of data, such as developments in claim frequency or judgment amounts, that remain the property of individual companies if not shared in collaborative activities.

Although conducting trending analysis through a rating association avoids duplication of effort, this kind of analysis is not an exact science. The presence or absence of a trend is often a matter of judgment, as is the evaluation of whether a given trend will wax, wane, or remain constant.

¹⁴⁴ See Insurance Services Office, Inc., *Using the Past to Predict the Future: Historical Data, Loss Development and Trend* 7 (1989).

¹⁴⁵ See id. at 10.

Industry-wide reliance on the trending analysis of a rate-making bureau might actually end up being inefficient because if the trending proves to be inaccurate the result would be industry-wide mispricing, whereas if many firms performed their own analyses the combined contribution of the different assessments might produce a more informed market price. Moreover, smaller firms would not be precluded from obtaining trending information in the absence of an industry-wide rating bureau; presumably consulting firms would be ready and willing to conduct trending analysis and sell the results to numerous companies.

Trending analysis also may include projected administrative costs of claims resolution. These costs include the costs of processing claims as well as anticipated litigation costs from claims that are not resolved at the administrative level. There appears to be little economic rationale for the provision by rating bureaus of predictions about future costs of claims processing and litigation. Each individual firm is best equipped to predict its own expenses, which vary across firms because of a multitude of factors. Lumping administrative and litigation expenses together into a broad-based average, developing the information to account for predicted future expenses, and supplying the analysis back to the industry appear to provide little information of real value.

Given all these considerations, although the question is a close one, cooperative efforts at trending analysis probably should be permitted from an efficiency standpoint, although the legal system should be diligent to ensure that trending is not used as an aid to the establishment of standardized rates among competing firms.

Rating bureaus have traditionally incorporated all of their data analyses into *final advisory rates*.¹⁴⁶ These advisory rates are based on the bureaus' analyses of historical loss costs and prospective loss costs, but include a loading for operating expenses and profit as well. We see no justification for the provision of *general expense information* by a centralized industry rating bureau as an incident to the development of final advisory rates. There is no reason to suppose that a rating bureau would be in any better position to predict future costs of operation than would an individual insurance company. Costs of operation vary across firms for many different reasons. Overhead, marketing, employee compensa-

¹⁴⁶ It should be noted in this regard that the major industry rating associations are moving towards limiting the types of information they supply to firms in order to reduce their potentially anticompetitive effects. Both the ISO and the NCCI are shifting from advisory rates towards a focus on historical loss data. See note 143 and accompanying text *supra* (discussing ISO and NCCI). The ultimate effect of these changes may be to move the industry in the direction of free competition over rates. See Kevin Thompson, *McCarran-Ferguson Repeal and ISO's Advisory Rate Ban: A Chance for Compromise?*, 17 N. Ky. L. Rev. 373, 388-89 (1990).

tion, and many other costs vary from firm to firm; there is no reason therefore to believe that any particular figure for such expenses is optimal. Because each firm is the best judge of its future expenses, the rating bureaus provide little information of economic value when they derive average expense figures to be used in the process of setting advisory rates.

Nor, in our view, is there any economic justification for a rating bureau's use of a *standardized provision for profit* in the derivation of advisory rates. The profit which a given firm can expect to earn in a competitive marketplace is a function of many factors, some firm-specific, some industry-specific, and some cutting across industries. Insurance firms receive no information of economic value—other than information that might facilitate anticompetitive pricing policies—when centralized rating bureaus set forth standardized profit margins for the industry as a whole.

The least justification inheres in the promulgation of the *final advisory rates* themselves. Advisory rates provide no real information to firms beyond what the firms could provide for themselves, other than information about the price the firm is expected to charge and what price other firms will charge. There is no basis for supposing that firms are unable to set their own rates, once they have the necessary cost information. Nor is there any plausible argument that rate setting by an industry bureau avoids an inefficient duplication of efforts by the individual firms. Firms in every competitive industry set their own prices, yet we do not imagine that the research and analysis that go into these pricing decisions represent some sort of inefficient duplication of effort that should be avoided by reference to a single pricing bureau. Insurance is no different. The fact is that advisory rates serve little function other than discouraging competition.¹⁴⁷

Overall, then, our analysis suggests that the economic argument in favor of the use of pooled information for purposes of setting price depends upon the nature of the information at issue. The argument is persuasive with respect to historical loss data and developed loss costs, weaker, but still persuasive, with respect to trend analysis, and unpersuasive as applied to final advisory rates.

The fact that sharing of data within the industry is economically efficient in limited circumstances, however, does not necessarily translate

¹⁴⁷ For the argument that widespread use of advisory rates contributed to the insurance crises of the 1980s, see Jay Angoff, *Insurance Against Competition: How the McCarran-Ferguson Act Raises Prices and Profits in the Property-Casualty Insurance Industry*, 5 *Yale J. on Reg.* 397, 406-08 (1988). For a different and more plausible explanation of the insurance crisis, see George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 *Yale L.J.* 1521, 1563-82 (1987) (arguing liability insurance crisis was caused by judicial compulsion of excessive levels of third-party insurance for victims).

into an argument for retaining the McCarran-Ferguson Act's antitrust exemption. As will be seen below,¹⁴⁸ existing doctrine under federal antitrust law would allow firms in the industry to share data freely, without fear of antitrust liability, in many cases where such data sharing is economically desirable. Nevertheless, we will argue that, on balance, the case for repealing the Act's antitrust exemption is not established, provided that existing law adequately polices against cooperative activities in the industry that pose serious threats to competition.

b. Standardizing Policy Forms. A second argument in favor of the antitrust exemption is that it allows the use of standard policy forms, which have traditionally been promulgated by the industry's rating bureaus.¹⁴⁹ Standardized policy forms may be said to serve several social goals. First, they arguably facilitate comparison shopping by consumers, because with a standard form in place, a consumer need only shop around

on the basis of price. If forms were not standardized, on the other hand, the consumer would have a difficult time comparing policies, because the lower price of one policy might be more than offset by the reduced coverage offered by that policy. Without standardized forms, consumers would have to wade through the fine print of each policy to assess the effective costs of the various deductibles, exclusions, and exemptions. This is time consuming for the consumer; but, more importantly, the consumer lacks a methodology for determining the actual economic value of particular items of coverage, since that value can be determined only through the sorts of actuarial analyses that are now conducted by firms and rating bureaus. In the absence of effective comparison shopping, the industry is likely to be less efficient and less competitive.

Another important economic advantage of standardized forms is that they facilitate the compilation of data necessary for the analysis of risk categories and severity. In the absence of form standardization, it would be difficult to compile an adequate statistical data base on which to base risk assessments.

Finally, language in standardized forms comes to reflect judicial and administrative decisions and becomes more precise over time. Other things being equal, it is desirable for all parties that the terms of the policy be precise and determinate in order to reduce the frequency of

¹⁴⁸ See notes 160-73 and accompanying text *infra*.

¹⁴⁹ The actual degree of standardization imposed by the rating bureaus depends on the nature of the policy. Policies are least standardized in commercial lines, where the size of the policy and the uniqueness of the risks involved often result in individual negotiation of important policy terms. Personal lines such as homeowners', automobile, and health insurance are more standardized.

coverage disputes. The need for clear terms is particularly compelling in the insurance industry due to the danger of opportunistic behavior in contract interpretation by both the insured and the insurer at the time a claim is made.

These are significant advantages. In our view, the advantages are sufficiently great as to justify a wide range of cooperative behavior within the industry intended to develop and refine standardized forms.

However, the advantages of standardized forms do not necessarily justify the establishment of industry-wide uniform policies that exclude the use of forms or policies other than the standardized models: the standard forms should be suggested only, and should not be exclusive of standard forms proposed by others, of firm-specific forms, or of individually negotiated forms. If it is unacceptable for insurance companies or groups to impose standard forms on the rest of the industry, granting power to a rating bureau to enforce or compel the use of standardized forms clearly goes beyond these limited economic justifications. As such, the ultimate decision as to which forms prevail in the industry can and should be left to market forces.

c. Preserving Competition. Two related arguments offered in favor of the antitrust exemption focus on the effects that federal antitrust regulation has on the competitiveness of the insurance market. The first such argument posits that smaller firms "may be forced to go out of business entirely or be absorbed by larger companies"¹⁵⁰ if the antitrust exemption were repealed. If insurance firms are not allowed to share information, so the argument goes, smaller firms will suffer disproportionately. Only larger firms will be able to assess future losses accurately because their own operations will give them access to a large data set of historical costs and because the expenses of trending and analysis can be spread over their large policyholder base. Thus, in the absence of information sharing, the insurance industry would be forced to restructure, with costly and disruptive departures of smaller firms from the market. The end result, according to this argument, would be an industry concentrated in a few large and potentially oligopolistic firms.

There is probably some truth in the prediction that repeal of the antitrust exemption would harm smaller firms. But the principal "harm" from applying the antitrust laws to the insurance industry would not be to smaller firms per se, but to inefficiently managed firms that cannot compete when prices are set at competitive, market-clearing levels. Most of these inefficient firms may well be some of the industry's smaller firms,

¹⁵⁰ See Achampong, *supra* note 141, at 167 (arguing that inability to share data would affect smaller companies' ability to set adequate and competitive rates, thereby risking their insolvency); see also H.R. 9 Hearings, *supra* note 10, at 48 (statement of Sen. Roy Woodall, Jr.).

not only because smaller firms are likely to be less efficiently managed in some cases, but also because most firms in the industry are small relative to the ten or twenty largest firms. But many small firms are likely to survive and even prosper under a regime of truly competitive pricing. Economies of scale in the insurance industry, while they exist, are not nearly as pronounced as in many other industries.¹⁵¹ Some states, such as Illinois, have operated with competitive pricing for many years now, and there has been no major shakeout among the smaller firms. The testimony from the banking industry suggests that a smaller firm can do well, even in head-to-head competition with industry giants, if it is well-managed and maintains good customer relations.¹⁵²

Finally, there is no valid economic reason to maintain small firms in operation, simply because they are small, if they are inefficiently managed. Propping up badly managed or inefficiently organized firms harms consumers by subsidizing inefficient producers at the expense of efficient ones; it rewards poor performance rather than good performance; and it reduces the efficiency of the insurance function within the economy as a whole. A regulatory regime in which insurance firms were not allowed to fail would be undesirable as a matter of public policy.¹⁵³ Application of the antitrust laws to the insurance industry would no doubt increase the incidence of insurance company failures at the margin, but failure is the inevitable result of a price system which offers great benefits to consumers of insurance products and to the economy as a whole.

The other competition-based argument offered in favor of the anti-trust exemption focuses on the lack of concentration in the insurance industry, and posits that repeal of the McCarran-Ferguson Act would reduce competition and harm the interest of consumers. Proponents of the exemption first observe the large number of insurance providers in the marketplace—by one account, nearly 6000 life, health, and property/

¹⁵¹ See Christopher Dauer, *Size No Object in Insurer Expenses*, Nat'l Underwriter (Property & Casualty/Risk & Benefits Mgmt. Ed.), Oct. 29, 1990, at 31 (reporting study showing that "the size of an insurance company is not a major determinant of efficiency"); Randall Geehan, *Returns to Scale in the Life Insurance Industry*, 8 Bell J. Econ. & Mgmt. Sci. 497, 513 (1977) (finding only weak evidence of statistically significant returns to scale in the Canadian life insurance industry). But see generally Neil A. Doherty, *The Measurement of Output and Economies of Scale in Property-Liability Insurance*, 48 J. Risk & Ins. 390 (1981) (finding empirical evidence of significant economies of scale in Canadian property-liability insurance markets).

¹⁵² See, e.g., B. Frank King, *Upstate New York: Tough Market for City Banks*, Econ. Rev. of the Fed. Reserve Bank of Atlanta, June/July 1985, at 30 (noting success of smaller banks in upstate New York versus branches of larger New York City banks). The banking analogy is not exact, however, because even the smallest banks could offer accounts backed by federal deposit insurance, which is something that smaller insurance firms cannot do.

¹⁵³ See A. Dale Tussing, *The Case for Bank Failure*, 10 J.L. & Econ. 129, 146 (1967) (arguing that allowing bank failures could result in better societal resource allocation).

casualty companies and 400,000 agents.¹⁵⁴ This market is also extraordinarily unconcentrated in virtually all product lines: for instance, in the property/casualty line, "no single firm has more than 10% of the national market, and the 10 largest companies account for less than 40 percent of the premium volume."¹⁵⁵

Given this dramatic lack of concentration, the proponents of the antitrust exemption conclude that the industry is obviously highly competitive,¹⁵⁶ suggesting that federal antitrust scrutiny is not needed to enhance competition. Rather, they suggest that federal scrutiny would actually reduce competition in the industry, because the inevitable effect would be to drive many of the smaller to mid-sized firms from the market, concentrating the industry and facilitating anticompetitive behavior.¹⁵⁷

This argument is not well-taken. The fact that the industry is unconcentrated does not necessarily establish that it is competitive; on the contrary, the opposite may be true. Above-market pricing can still occur in an unconcentrated industry if there is either a highly effective cartel in operation, or if prices are set above market-clearing levels by government fiat. Until fairly recently, for example, the nation's approximately 12,000 commercial banks operated under governmentally mandated price controls which limited the amounts banks could pay in interest to depositors and prohibited the payment of any interest at all in the case of checking accounts.¹⁵⁸ These price controls, combined with other regulations, permitted many smaller banks to survive and therefore contributed to a highly unconcentrated industry. But it would strain credulity to suggest that the banking industry was fully competitive at the time; it could not have been fully competitive since banks were prohibited from competing on the basis of price in their most important market.¹⁵⁹ In the insurance industry, the prices of contracts with policyholders has been regulated similarly through government price controls. The pervasive presence of these price regulations suggests that the large number of insurance companies might reflect government price protection rather than vigorous

¹⁵⁴ See H.R. 9 Hearings, *supra* note 10, at 49 (statement of S. Roy Woodall, Jr.). The numbers have also been increasing: in 1979, there were 1895 U.S. life insurance firms; in 1989, there were 2350. See American Council of Life Ins., 1990 Life Insurance Fact Book 103 (1990) [hereinafter ACLI Fact Book].

¹⁵⁵ Insurance Info. Inst., 1990 Property/Casualty Insurance Facts 10 (1990).

¹⁵⁶ See, e.g., Muhl, *supra* note 137, at 28, 30 (stating that most property/casualty carriers are small or medium-sized firms with little market share); Franklin W. Nutter, *The Flawed Consumer Agenda*, *Best's Rev.*, Mar. 1991, at 28-29 (arguing that current system has fostered industry with large number of sellers, each with small market share).

¹⁵⁷ See Muhl, *supra* note 137, at 30; Nutter, *supra* note 156, at 28-29.

¹⁵⁸ See Geoffrey P. Miller, *The Future of the Dual Banking System*, 53 *Brook. L. Rev.* 1, 2-3 (1987).

¹⁵⁹ See *id.*

competition.

It may well be that application of federal antitrust scrutiny to the insurance industry will lower profit margins in the industry and drive some firms out of business. However, as we have illustrated, the loss of these firms represents a social benefit, since almost by definition the firms forced to leave the industry or merge with other providers would be less efficient. The industry is so highly unconcentrated that the departure of even large numbers of firms would not cause significant concerns about competition.

2. *The Effects of Repealing the Antitrust Exemption*

The advisability of the antitrust exemption under the McCarran-Ferguson Act also must be evaluated in light of the fact that many of its purported benefits could be achieved under conventional exceptions to the federal antitrust laws. These doctrinal exceptions include the rules permitting cooperative sharing of information, the *Noerr-Pennington* exemption for cooperative lobbying activities, and the state action doctrine. After discussing these conventional exceptions, this Section also examines briefly the boycott exception to the antitrust exemption to determine whether its increasingly expansive interpretation would permit the occurrence of anticompetitive behavior in the first instance.

a. *Cooperative Research.* As we have seen, one of the principal justifications for the antitrust exemption is the bona fide need of insurance companies to share information regarding risks and to cooperate in the development of standardized forms.¹⁶⁰ The possibility that federal antitrust laws would prohibit or seriously impede these cooperative activities would be a good reason for retaining some of the protections from antitrust scrutiny. As currently administered and enforced, however, the federal antitrust laws may not seriously impair the ability of insurance firms to engage in a considerable amount of bona fide information sharing or cooperative research in the identification and quantification of risks.

The federal antitrust laws have, for many years, been administered with sensitivity to the legitimate needs of industry participants to share certain types of information.¹⁶¹ As the Department of Justice observed

¹⁶⁰ See notes 140-47, 149 and accompanying text *supra*.

¹⁶¹ See generally AEI Study, *supra* note 12, at 52-55 ("[T]he antitrust laws clearly permit the joint performance of certain functions, including the formulation of a classification system and statistical plan, and the collection, compilation, and dissemination of past loss and expense data. On the other hand, the projection of future rates, or any large component thereof, would likely fall within the prohibitions of the Sherman Act.").

in a 1977 study, *The Pricing and Marketing of Insurance*,¹⁶² existing anti-trust law does not prevent competing businesses from undertaking joint activities involving economies of scale, and which realistically cannot be undertaken by competitors acting alone, so long as the activities in question do not unnecessarily harm competition.¹⁶³

In 1980, the Justice Department again emphasized the permissibility, under federal antitrust law, of research projects conducted through trade associations or industry joint ventures.¹⁶⁴ Such joint ventures are evaluated under a rule of reason standard, and are upheld against anti-trust attack if they have a legitimate business purpose, do not hamper competition, and promise benefits to the public.¹⁶⁵ As a practical matter, joint research ventures rarely are challenged under the Sherman Act,¹⁶⁶ particularly if the industry involved is not highly concentrated.¹⁶⁷

Finally, Congress recognized and codified the public policy objective of protecting bona fide cooperative research from antitrust scrutiny in the National Cooperative Research Act of 1984 (NCRA).¹⁶⁸ The statute provides that in any action under the federal antitrust laws,

the conduct of any person in making or performing a contract to carry out a joint research and development venture shall not be deemed illegal per se; such conduct shall be judged on the basis of its reasonableness, taking into account all relevant factors affecting competition, including, but not limited to, effects on competition in properly defined, relevant research and development markets.¹⁶⁹

A "joint research and development venture" is defined to include: theoretical analysis, "the systematic study of phenomena or observable facts," "the extension of investigative findings or theory of a scientific or

¹⁶² U.S. Dep't of Justice, Report to the Task Group on Antitrust Immunities: *The Pricing and Marketing of Insurance* (1977).

¹⁶³ *Id.* at 146-76.

¹⁶⁴ See U.S. Dep't of Justice, Antitrust Guide Concerning Research Joint Ventures (1980).

¹⁶⁵ Cf. *Broadcast Music, Inc. v. Columbia Broadcasting Sys.*, 441 U.S. 1, 23-24 (1979) (joint activities which arguably reduce costs and facilitate efficient marketing of products will be reviewed under a rule of reason under antitrust laws).

¹⁶⁶ See ABA Antitrust Section, *Antitrust Law Developments* 52 (2d ed. 1984).

¹⁶⁷ Cf. *United States v. Container Corp. of America*, 393 U.S. 333, 337 (1969) (high degree of concentration in corrugated container industry presented grounds for suspicion of exchange of price information among competing firms). See generally Herbert Hovenkamp, *Economics and Federal Antitrust Law* 110-24 (1985) (discussing application of federal antitrust law to cooperative information-sharing activities).

¹⁶⁸ Pub. L. 98-462, 98 Stat. 1815 (1984) (codified at 15 U.S.C. §§ 4301-4305 (1988)). The NCRA has yet to be applied to the insurance industry, so that the statute's technical implications for insurance are still undefined.

¹⁶⁹ 15 U.S.C. § 4302 (1988). In addition to providing that joint research and development activities be reviewed on a rule of reason standard, the NCRA limits the damages available in private antitrust actions based on such activities, see *id.* § 4303, and permits awards of attorneys fees to prevailing defendants if a claim is found to be frivolous, unreasonable, without foundation, or in bad faith, see *id.* § 4304(a).

technical nature into practical application for experimental and demonstration purposes,” and “the collection, exchange, and analysis of research information.”¹⁷⁰ Protected activities do not include exchanges of information among competitors that are “not reasonably required to conduct the research and development that is the purpose of such venture,”¹⁷¹ nor do they extend to conduct or agreements which involve production or marketing as opposed to research and development (other than agreements relating to the marketing of the proprietary research information itself).¹⁷²

Because the NCRA subjects cooperative research to a rule of reason antitrust analysis, it does not operate as a complete safe harbor for bona fide information sharing. Nevertheless, its practical effect would be much the same as a safe harbor, for once the analysis is phrased in terms of a rule of reason, all the economic justifications for a given activity are admissible into evidence.¹⁷³

In sum, it is virtually inconceivable that a bona fide information pooling venture for historical loss costs in the insurance industry would be subject to a successful antitrust challenge. It also is unlikely that existing antitrust law would reach legitimately procompetitive information-sharing activities such as the preparation, dissemination, and filing of policy forms and classifications, participation in joint underwriting or pools for residual risks, sharing of information relating to fraudulent claims, or certain types of shared research and inspections for the purpose of risk classification.

This analysis suggests that even the repeal of the antitrust exemption would not necessarily bar economically justifiable types of cooperative activities that economic theory suggests should be undertaken. Nevertheless, enough uncertainty exists in this area to warrant retaining the existing exemption, provided that it is interpreted to permit vigorous antitrust enforcement against those cooperative activities that harm or threaten to harm the competitive process.

b. Lobbying. Another type of collaborative industry activity that would survive the repeal of the antitrust exemption is political lobbying

¹⁷⁰ Id. § 4301(a)(6). The term “joint research and development venture” also specifically includes the establishment and operation of facilities for the conduct of research, and the conducting of such a venture on a protected and proprietary basis. Id.

¹⁷¹ Id. § 4301(b)(1).

¹⁷² See id. § 4301(b)(2). Also excluded are agreements restricting use of inventions or developments not developed through a research and development venture, or unreasonably regulating participation by a party in other research and development activities. See id. § 4301(b)(3).

¹⁷³ See H. Hovenkamp, *supra* note 167, § 4.4 at 124-34.

protected by the *Noerr-Pennington* doctrine.¹⁷⁴ Cooperative activities by insurance firms for the purpose of sharing information or even developing proposed rates easily can be characterized as a form of petitioning state regulators in an attempt to influence state policy, and accordingly might be protected by the *Noerr-Pennington* doctrine. Thus, even if the antitrust exemption were repealed, the *Noerr-Pennington* doctrine would offer another potential bulwark to protect collective rate-making activities.¹⁷⁵

It is unlikely, however, that the *Noerr-Pennington* doctrine would be extended so far as to immunize private activity which fixes prices or otherwise restrains competition, even if its ostensible purpose is to influence government action. The leading case addressing this issue is *United States v. Southern Motor Carriers Rate Conference*,¹⁷⁶ in which the Fifth Circuit held that the *Noerr-Pennington* doctrine did not immunize rate-setting activities by private motor carrier rate bureaus, even when the purpose of such activities was to develop joint rates to be filed with state regulatory bodies.¹⁷⁷ Thus, while the *Noerr-Pennington* doctrine will protect a range of cooperative action between insurance companies for the purpose of inducing political action, it is unlikely to interfere with valid state efforts to regulate anticompetitive rate-setting activities.

c. *State Action*. The final and most important doctrinal exception to the antitrust laws is the "state action" immunity of *Parker v. Brown*.¹⁷⁸

¹⁷⁴ See *Eastern R.R. Presidents Conference v. Noerr Motor Freight, Inc.*, 365 U.S. 127, 136-38 (1961) (holding that Sherman Act did not prohibit group of railroads from collectively lobbying legislature, regardless of anticompetitive purpose); *United Mine Workers v. Pennington*, 381 U.S. 657, 669-70 (1965) (same); *California Motor Transp. Co. v. Trucking Unlimited*, 404 U.S. 508, 510-11 (1972) (holding plaintiffs could not establish as a matter of law that damages had resulted from defendants' efforts to lobby Secretary of State).

¹⁷⁵ For an analysis concluding that the *Noerr-Pennington* doctrine protects a substantial range of collective conduct by the insurance industry, see Robert W. Hammesfahr, *Antitrust Exemptions Applicable to the Business of Insurance Other than the McCarran-Ferguson Act: the State Action Exemption and the Noerr-Pennington Doctrine*, 54 *Antitrust L.J.* 1321, 1329-31 (1985).

¹⁷⁶ 672 F.2d 469 (5th Cir. 1982), *aff'd en banc*, 702 F.2d 532 (1983), *rev'd on other grounds*, 471 U.S. 48 (1985).

¹⁷⁷ The court distinguished between the rate-setting activities, which were not protected under *Noerr-Pennington*, and the actual activity of presenting rates to the state commissions or of seeking regulatory permission to engage in joint activities. See *id.* at 477 ("While the joint efforts of the bureaus to secure legislation or commission regulation permitting collective ratemaking procedures would clearly fall within the ambit of *Noerr* protection, inasmuch as it would seek to influence policy, collective action to determine the rates which the bureaus desire the commission to approve is not of the same genre.").

¹⁷⁸ 317 U.S. 341 (1943). For a thorough discussion favoring state action immunity, see generally Merrick L. Garland, *Antitrust and State Action: Economic Efficiency and the Political Process*, 96 *Yale L.J.* 486 (1986).

Based on "principles of federalism and state sovereignty,"¹⁷⁹ the state action doctrine exempts anticompetitive activities from antitrust sanction when such activities are "clearly articulated and affirmatively expressed as state policy," and the policy in question is "actively supervised" by the state itself.¹⁸⁰ The first prong of this test is satisfied even if the state does not directly require the conduct in question, so long as it has evinced an "intent to establish an anticompetitive regulatory program."¹⁸¹ The second prong is satisfied if "state officials have and exercise power to review particular anticompetitive acts of private parties and disapprove those that fail to accord with state policy."¹⁸²

The degree of state involvement in rate setting necessary to trigger state action immunity is not clear for the obvious reason that the McCarran-Ferguson Act itself prevents the litigation of test cases to establish the boundaries of the doctrine in this context. Nevertheless, recent cases offer a glimpse of the rules that would likely be applied if the insurance industry were placed under the existing scheme of federal antitrust regulation.

In *Federal Trade Commission v. Ticor Title Insurance Co.*,¹⁸³ the FTC challenged alleged rate setting by title insurance companies for title insurance and examination. While the respective state insurance commissioners possessed the power to investigate the reasonableness of the rates and to veto them if unreasonable, they had conducted only minimal investigation and passively had allowed the rates promulgated by private rating bureaus to go into effect.¹⁸⁴ Nevertheless, the Third Circuit held that such collective rate setting was protected by the state action doctrine.¹⁸⁵ The court noted that the states had adopted a clearly articulated and affirmatively expressed policy to displace market rates, emphasizing that the state commissioners had approved the filing of collective rates, that the state statutes recognized the existence of private rating bureaus,

¹⁷⁹ 324 Liquor Corp. v. Duffy, 479 U.S. 335, 343 (1987).

¹⁸⁰ California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc. 445 U.S. 97, 105 (1980) (finding that California's mere authorization of price setting and enforcement of prices established by private parties did not meet state action requirement) (quoting City of Lafayette v. Louisiana Power & Light Co., 435 U.S. 389, 410 (1978) (opinion of Brennan, J.)).

¹⁸¹ Southern Motor Carriers Rate Conference, Inc. v. United States, 471 U.S. 48, 65 (1985). Thus, where an administrative agency is statutorily required to establish "just and reasonable" rates for an industry, the state action exemption protects collective rate making by firms if the agency so permits. *Id.* at 63-65.

¹⁸² Patrick v. Burget, 486 U.S. 94, 101 (1988).

¹⁸³ 112 S. Ct. 2169 (1992).

¹⁸⁴ See *id.* at 2174-75.

¹⁸⁵ Ticor Title Ins. Co. v. FTC, 922 F.2d 1122, 1124-25 (3d Cir. 1991). Because it held that the challenged activities were protected by state action immunity, the court did not address the defendants' argument that their actions were protected by the McCarran-Ferguson Act. See *id.*

and that a federal court should defer to the reasonable interpretations of state law by state administrative bodies.¹⁸⁶ The court further found that the states had engaged in the requisite active supervision of collective rate making¹⁸⁷ by "demonstrat[ing] some basic level of activity directed toward seeing that the private actors carried out the state's policy and not simply their own policy."¹⁸⁸

On appeal, the Supreme Court reversed.¹⁸⁹ Initially, the Court determined that the level of state supervision over the rates in question had failed to meet the minimum threshold for state action immunity, because "[a]ctual state involvement, not deference to private price fixing arrangements under the general auspices of state law, is the precondition for immunity from federal law."¹⁹⁰ Furthermore, the Court explained:

Where prices or rates are set as an initial matter by private parties, subject only to a veto if the State chooses to exercise it, the party claiming the immunity must show that state officials have undertaken the necessary steps to determine the specifics of the price-fixing or ratesetting scheme. The mere potential for state supervision is not an adequate substitute for a decision by the State.¹⁹¹

Ticor therefore suggests that the courts will not be willing to read the state action exemption very broadly in rate-setting cases. However, even under the terms of *Ticor*, a substantial range of private activity in the rate-setting area probably would qualify for state action immunity. For instance, as long as state insurance regulators actually review the filed rates for substance, require disclosure of information underlying the rates, and require demonstration that the information justifies the filed rates, it is likely that the collaborative activities of private parties in rate setting (subject to administrative review and potential disapproval) would remain within the ambit of state action protection.

Ticor also supports the view that the state action doctrine applies when the state affirmatively sets rates. When the rate setting is actually conducted by the state itself, the existence of state action is not an issue. Additionally, state action is probably present when a state requires that insurers engage in collaborative rate setting through rating bureaus (or similar mechanisms) and requires that the firms adhere to the rates so established. A requirement of cooperative action constitutes a clearly ex-

¹⁸⁶ See id. at 1129-40.

¹⁸⁷ See id. at 1140.

¹⁸⁸ Id. at 1139 (referring specifically to the activities of Montana, one of the states implicated in this case).

¹⁸⁹ *Ticor*, 112 S. Ct. at 2180.

¹⁹⁰ Id. at 2176-77.

¹⁹¹ Id. at 2179.

pressed state policy in favor of such activity, while the mandatory nature of such a system satisfies the second prong of the state action test, namely that the state actively supervise the private activity in question.

When the state does not affirmatively require collaborative rate setting, but nevertheless permits it to occur, the cases suggest the following. First, any statute that expressly authorizes rate setting by rating bureaus or other collaborative mechanisms should be sufficient to protect the cooperative activity under the state action doctrine *if* the state actively and meaningfully supervises the rate-setting activities to ensure compliance with the legislative goals. Second, even if a statute does not affirmatively authorize collaborative rate setting, the state action doctrine probably still would apply if the state insurance commissioner is empowered to establish rates, and, pursuant to that authority, allows collaborative rate setting under active and meaningful administrative supervision as an aid to determining rates.

State action immunity probably would not be found if the state insurance commissioner did not actively and meaningfully supervise the rate-setting activities of a private rating bureau to ensure case-by-case compliance with the commands of the applicable legislation or regulation. Furthermore, state action immunity probably would not apply in states which operate under free-market rate-setting regimes, even if the insurance commissioner permits collective rate-setting activities and retains discretionary power to reject rates deemed discriminatory, excessive, or inadequate. Such schemes would appear to reflect neither a clearly expressed state policy to displace market forces nor sufficiently active state supervision of the activities of private rating bureaus.

This analysis of the state action exemption suggests that a possible reaction to the repeal of the antitrust exemption would be a demand by insurance companies that state insurance codes be revised to ensure the availability of state action immunity in a wide range of private rate-setting activities. If successful, this strategy would ensure that industry participants enjoy the maximum discretion to set their own rates consistent with the doctrine of state action immunity. The Supreme Court's decision in *Ticor*, however, restricts the ability of private insurance companies to organize cartels without meaningful state supervision; and the actions of insurance commissioners presumably would be subject to some degree of political control to the extent that the commissioners actively cooperated with a private cartel to fix rates to the detriment of insurance consumers. Accordingly, the Supreme Court's current approach to state action, which significantly prunes back the expansive interpretations offered by a number of lower courts, is sufficiently well-defined and administrable to obviate the need for special legislation defining the scope

of state action in the insurance context.¹⁹²

d. The Boycott Exception. The practical scope of the McCarran-Ferguson Act's antitrust exemption—and therefore the impact of any congressional action repealing the exemption—depends crucially on the interpretation given to the boycott exception. Under the Act, the general antitrust exemption does not apply to “any agreement to boycott, coerce, or intimidate, or act of boycott, coercion or intimidation.”¹⁹³ If the boycott exception is construed broadly, the antitrust exemption loses much of its power to shield anticompetitive activities within the industry from antitrust scrutiny. As in the case of other key phrases in the McCarran-Ferguson Act, the boycott exception is susceptible to a variety of interpretations yielding important differences in outcomes.

Read most narrowly, the boycott exception would apply only to the principal abuse against which it appears to have been directed—the refusal by insurance companies to deal with independent agents or other insurance firms that engaged in rebating or other practices which firms within the industry wished to deter.¹⁹⁴ A broader reading would include any concerted activities directed at competitors or customers which have the purpose and effect of completely denying them the benefit of competition in “vital matters such as claims policy and quality of service.”¹⁹⁵

A still broader interpretation would bar concerted activities by insurance firms which have the purpose and effect of limiting access by customers, agents, or competitors to the benefits of competition in any aspect of the insurance business, even if they do not altogether foreclose market operation. This interpretation would allow firms to utilize cooperative rating bureaus to establish rates, but would deny them the power to enforce such rates once they had been established.

The Supreme Court wrestled with these issues in the leading case of *St. Paul Fire & Marine Insurance Co. v. Barry*.¹⁹⁶ The case involved an alleged conspiracy by medical malpractice insurers to refuse to deal with policyholders in a company which had altered its coverage from an “oc-

¹⁹² But see Achampong, *supra* note 141, at 152-55 (arguing that state action doctrine would provide insufficient protection to the insurance industry in the absence of an antitrust exemption, because the close supervision requirement would require discarding open competition for flex-rating or prior approval systems). Achampong's major concern, that in the absence of an antitrust exemption insurance companies will not be able to share loss data, is treated at notes 141-45 and accompanying text *supra*.

¹⁹³ 15 U.S.C. § 1013(b) (1988).

¹⁹⁴ This is the major abuse complained of in the legislative history. See, e.g., 91 Cong. Rec. 1485 (1945) (remarks of Sen. O'Mahoney).

¹⁹⁵ *St. Paul Fire & Marine Ins. Co. v. Barry*, 438 U.S. 531, 553 (1978). For an analysis that advocates roughly this reading, see Joseph E. Coughlin, *Losing McCarran Act Protection Through “Boycott, Coercion, or Intimidation,”* 54 Antitrust L.J. 1281 (1986).

¹⁹⁶ 438 U.S. 531 (1978).

currence" basis to a "claims made" basis.¹⁹⁷ The purpose of the alleged conspiracy was to prevent policyholders from switching insurers in response to the policy change.¹⁹⁸ The defendant insurers argued, *inter alia*, that the boycott exception did not apply to refusals to deal directed at customers rather than competitors.¹⁹⁹ The Supreme Court rejected this argument, holding that the exception "is not limited to concerted activity against insurance companies or agents or, more generally, against competitors of members of the boycotting group."²⁰⁰ The alleged practices under review amounted to a boycott under the statute because they "erected a barrier between St. Paul's customers and any alternative source of the desired coverage, effectively foreclosing all possibility of competition anywhere in the relevant market."²⁰¹

The *Barry* decision seemed to endorse the second interpretation of the boycott exception set forth above, since it emphasized the fact that all possibility of competition in the relevant market had been foreclosed. However, it left a great deal unresolved because the presence or absence of a boycott under *Barry* appeared to depend on a quantitative analysis of the extent to which the concerted activity in question interferes with competitive forces.²⁰² Activities such as those found to have occurred in *Barry*, which completely foreclosed all possibility of competition anywhere in the market, were within the boycott exception, but the application of the exception to activities which interfered with competition only partially remained unclear.

The Supreme Court clarified the scope of the boycott exception in another important recent case, *Hartford Fire Insurance Co. v. California*.²⁰³ California and other states challenged certain activities by major insurers in the commercial general liability (CGL) insurance business. The states claimed that the defendants had engaged in a pattern of coercion in an attempt to force the Insurance Service Office (ISO)—an organization of insurance firms which promulgates standard contracts for the property/casualty industry—to modify its standard CGL insurance form.²⁰⁴ The complaint alleged that the defendants had refused to deal with the old CGL form, thus effectively forcing the entire industry to adopt the coverages favored by the defendants.²⁰⁵ The consequence, according to the complaint, was that certain forms of CGL coverage be-

¹⁹⁷ *Id.* at 534-35.

¹⁹⁸ *See id.* at 535, 552.

¹⁹⁹ *See id.* at 546-51.

²⁰⁰ *Id.* at 552.

²⁰¹ *Id.* at 553.

²⁰² *See id.* (focusing on total elimination of competition).

²⁰³ 113 S. Ct. 2891 (1993).

²⁰⁴ *See id.* at 2897-99.

²⁰⁵ *See id.* at 2898.

came unavailable.²⁰⁶

The Supreme Court held that the allegations in the complaints, construed most favorably to the complainants, were sufficient to allege a boycott within the meaning of the boycott exception and thus to withstand a motion to dismiss.²⁰⁷ The Court distinguished a boycott from a concerted agreement as to terms.²⁰⁸ Parties who agree to terms and then refuse to deal with others except on those terms are engaged in cartelization, not boycott. The essence of a boycott, in the Court's view, is that transactions not directly related to the targeted transaction are used as leverage to achieve the end desired.²⁰⁹

The *Barry* and *Hartford Fire Insurance Co.* cases have interpreted the boycott exception in such a way as to permit cooperative price-fixing arrangements but to remove most, if not all, practical devices (short of state action) for enforcing such agreements. For example, if insurance companies agreed jointly on a price to charge for a particular policy premium, this in itself would not amount to a boycott under *Hartford Fire Insurance Co.*, since the agreement does not involve a refusal to deal on matters collateral to the basic agreement. However, if the agreement in addition included an arrangement whereby insurance companies that refused to honor the price-fixing agreement were punished by some type of collateral sanction, the arrangement would go beyond a concerted agreement to terms because coercive pressure not directly related to the basic arrangement would then be part of the understanding. Thus, while the boycott exception does not subject collective agreements as to price or policy forms to the federal antitrust laws, it makes it difficult for the parties to an agreement to organize an effective system of sanctions to penalize defections from a cartel once established.

For reasons already discussed, the arguments in favor of cooperative activities by insurance firms do not justify coercive measures by industry participants that force others to adhere to recommended terms or policies. The arguments in favor of cooperation have to do with the provision of information, not with coercing uniformity. Thus, the relatively expansive interpretation of the boycott exception found in the recent Supreme Court cases appears to represent sound social policy. Under such an interpretation, the antitrust exemption for cooperative activities generally seems less problematic than might otherwise appear, since the antitrust laws are not precluded from policing against the application of economic leverage to coerce compliance with cartel policies or prices.

²⁰⁶ See *id.*

²⁰⁷ *Id.* at 2895-2900.

²⁰⁸ *Id.* at 2912.

²⁰⁹ *Id.*

3. *Conclusions*

As this Section has shown, the antitrust exemption of the McCarran-Ferguson Act should be interpreted to enhance competitive forces in the insurance industry, while not impairing the ability of industry members to engage in socially desirable cooperative activities. Accordingly, the boycott exception to the Act should be interpreted to police against the danger of cooperation among firms to coerce others to charge uniform rates, use particular forms, or the like. For similar reasons, state action immunity should be limited to situations in which the state has actively and continuously regulated the activities in question.

The antitrust laws should not apply, however, to cooperative efforts at sharing and analyzing historical loss cost or prospective loss cost information. Likewise, it is important that firms in the industry have access to standardized forms if they wish to use them. If legitimate activities are threatened by the federal antitrust laws, it may be desirable to implement safe harbors expressly protecting activities where economic benefits outweigh the possible dangers to competition.²¹⁰ We believe that appropriately crafted safe harbors could address problems confronting the industry to the extent that the antitrust laws are made applicable to the business of insurance in the future.²¹¹

In general, recent interpretations of the McCarran-Ferguson Act have adopted reasonable constructions of the statute. Thus, we do not believe the Act needs fundamental modification or repeal at this time. If, however, the statute were to receive a judicial construction that interfered with the power of the federal antitrust laws to police against threats to competition within the industry, we would then recommend that Congress consider repealing the immunity while at the same time providing explicit safe harbors for economically efficient cooperative activities that do not pose serious threats to competition—the sharing and cooperative analysis of historical and prospective loss cost data and the cooperative development of standardized forms.

B. Solvency Regulation

This Section considers the impact of the McCarran-Ferguson Act in

²¹⁰ If a safe-harbor approach is adopted, the statute or legislative history should specify that the express mention of certain safe harbors is not in derogation of other permissible cooperative activities, the likely economic benefits of which outweigh the possible dangers to competition.

²¹¹ The safe-harbor approach discussed here resembles a number of recent proposals, including those of the ABA's Commission to Improve the Liability Insurance System, which recommended in 1989 that the antitrust exemption be repealed, subject to a limited authorization "to engage in specified cooperative activity that is shown to enhance the competitiveness of the industry." ABA, Report of the Commission to Improve the Liability Insurance System, Recommendation 3.1(1) (1989).

the area of state solvency regulation—arguably a more important aspect of the statute than the better-known antitrust exemption.²¹² The adequacy of state solvency regulation has recently come under attack from many quarters. The House Energy and Commerce Committee's Subcommittee on Oversight and Investigations held hearings on insurance company insolvencies, and issued their findings in *Failed Promises: Insurance Company Insolvencies* (popularly known as the "Dingell Report").²¹³ The General Accounting Office has also issued reports criticizing the existing system of state solvency regulation.²¹⁴ Meanwhile, Public Citizen, a Ralph Nader-affiliated "public interest" group, asserted in October 1990 that five of the top twenty property/casualty firms might fail in the event of an economic downturn.²¹⁵ And while the organization was subsequently forced to retract these charges with respect to several of the named firms,²¹⁶ the widespread publicity still reduced consumer confidence in the solvency of the insurance industry as a whole. Finally, congressional dissatisfaction with state solvency regulation has generated proposed legislation,²¹⁷ and even a few voices within the industry itself have expressed a surprising openness to federal solvency regulation.²¹⁸

Yet despite the appearance of crisis created by such reports, a careful examination of the actual facts in the insurance business indicates that the industry is not experiencing a solvency crisis. While there have been several widely publicized failures, most insurance firms are solvent and well-capitalized. As such, the analogy to the banking industry's insolvency crisis is at best misleading, and at worst plainly false. Moreover, states are now proceeding aggressively to improve and strengthen their solvency regulation, which was relatively well-designed before the

²¹² See Kimball & Heaney, *supra* note 26, at 2 (eliminating antitrust exemption "would leave the most important part of the [McCarran-Ferguson] Act intact").

²¹³ Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce, *Failed Promises: Insurance Company Insolvencies*, H.R. Doc. No. 362-3, 101st Cong., 2d Sess. (1990). The House Subcommittee on Commerce, Consumer Protection and Competitiveness also held hearings on similar subject matter. See *Life Insurance Solvency Issues*, July 17, 1991: Hearings Before the Subcomm. on Commerce, Consumer Protection and Competitiveness, H.R. Doc. No. 361-58, 102d Cong., 1st Sess. (1991).

²¹⁴ The vigor of state closure policies comes under fire in General Accounting Office, *Insurance Regulation: State Handling of Financially Troubled Property/Casualty Insurers*, Report to the Chairwoman, Subcomm. on Commerce, Consumer Protection and Competitiveness, House Comm. on Energy and Commerce, H.R. Doc. No. 361-58, 102d Cong., 1st Sess. (1991).

²¹⁵ See Editorial Comment, *A Disservice to Public Citizens*, Nat'l Underwriter, Nov. 26, 1990, at 16.

²¹⁶ See *id.*

²¹⁷ See text accompanying notes 254-66 *infra*.

²¹⁸ The American Insurance Association (AIA), which represents larger insurance companies who hold about 40% of the market for commercial lines, has stated it is keeping an "open mind" regarding federal solvency regulation. See Hall, *supra* note 12, at 109.

current round of legislative changes. Also, since any proposal for federalizing state solvency regulation must consider whether the federal government could do a better job at protecting policyholders, the shameful failure of the Federal Home Loan Bank Board in preventing thrift industry insolvency suggests there is little reason to believe that a federal agency would do a better job. In short, the case for federal solvency regulation is not persuasive.²¹⁹

1. *Current Solvency Conditions*

In recent years, the insurance industry has faced significant strains on its solvency. In many respects, the causes of instability in the insurance business are similar to the problems plaguing the banking industry: heavy investments in the most dramatically deflated commercial real estate market since the Great Depression,²²⁰ and large stakes in junk bond issues which have subsequently soured.²²¹ According to one study, the ratio of high-risk assets (junk bonds and troubled real estate investments) to total surplus (statutory surplus plus mandatory securities valuation reserve) jumped from 91% in 1989 to 140% in 1990.²²²

Yet at the same time, it is unlikely that the insurance industry as a whole will experience the sorts of catastrophic failures that occurred in the thrift and commercial banking industries. One essential distinction between these industries is that insurance firms are not constrained by

²¹⁹ But see AEI Study, *supra* note 12, at 95 (recommending federal solvency regulation and noting the "probable necessity for a federally established guaranty fund in the event of the sudden, unpredicted demise" of insurance companies doing business under federal auspices). It is worthy of note that AEI's study was conducted well before the failures in the bank and thrift deposit insurance systems and the reevaluation of deposit insurance which has followed those financial disasters.

²²⁰ The actual number of firms with serious real estate problems is relatively small, however. As of April 1991, only about a dozen life insurance firms had mortgage problems and defaults in excess of 40% of surplus. See Gil Marmol & John Shuck, *Testing the Mettle of Life Insurers*, *Best's Rev.*, Apr. 1991, at 16. These firms, however, include some of the major companies in the industry. See *id.* The industry's overall investment in real estate has decreased steadily since 1966, when mortgages constituted 38.6% of the total assets of life insurance firms, to only 19.5% in 1989. See ACLI Fact Book, *supra* note 154, at 94. Real estate owned outright has remained close to 3% of total assets since 1960. See *id.* at 98.

²²¹ Almost all investment in junk bonds was by the life insurance sector; casualty/property firms did not buy large volumes of high-yield debt, and junk bonds represented only one percent of total assets in 1988. See Russ Banham, *Junk Jitters*, 51 *Ins. Rev.*, No. 4, Apr. 1990, at 10. Even in the life insurance sector, however, the number of firms with heavy exposure in junk bonds is small, although involved firms are large. By April 1991, it was estimated that 37 life insurance companies, accounting for 16% of the industry's invested assets, had junk bond portfolios in excess of 100% of surplus; 12 companies had junk bond portfolios in excess of 200% of surplus. See Marmol & Shuck, *supra* note 220, at 16. Overall, only 4.8% of the total assets of life insurance companies are invested in junk bonds. See *id.*

²²² See Frederick S. Townsend, *High Risk Assets: 140% of Total Surplus*, *Nat'l Underwriter*, June 3, 1991, at 3.

the restrictive asset rules that apply to banks and thrift institutions, and thus they are better able to diversify their investment portfolios.²²³ Furthermore, unlike banks and thrifts, insurance companies do not offer risk-free investments that can be marketed nationwide and used to postpone the failure of fundamentally unsound institutions. Federal deposit guarantees and the highly liquid nature of bank deposit accounts allowed many banks and thrifts to expand their deposit bases and grow dramatically in size, while at the same time investing the deposited funds in unsound or highly speculative ventures. Needless to say, many of these fast-growing depository institutions subsequently have failed. However, this strategy is not readily available to insurance firms because the insurance product is neither as risk-free nor as liquid as bank certificates of deposit. While some insurance firms in the 1980s did offer investment vehicles such as annuity contracts and did attempt to grow quickly by offering cheap premiums, this group represents only a small segment of the market (although a large percentage of the insurance companies that have failed).²²⁴ Thus, even if insurance firms were inclined to adopt a risky investment strategy, they could not leverage a federal deposit guarantee to expand indefinitely at the ultimate expense of the taxpayers.

Furthermore, the actual condition of the insurance industry is nowhere near as troubled as that of the banking industry during the 1980s. Although a few firms have failed, the failures have not been catastrophic and have represented only a small percentage—less than one percent—of the total firms in the industry.²²⁵ Additionally, some firms commonly considered to have failed, such as Mutual Benefit Life and Monarch Life,

²²³ Many insurance firms are allowed to invest some of their portfolios in equity securities. See ACLI Fact Book, *supra* note 154, at 83 (as of 1989, 9.7% of life insurance company assets were held in corporate equity securities). Junk bonds in particular had less appeal to insurance companies than they did, for example, to savings and loan institutions, because insurance firms could seek high returns in equity markets, and the relatively strong stock market bolstered the insurance industry's investment returns at a time when many junk bond portfolios were performing badly.

²²⁴ The growth patterns of firms involved in some of the most prominent recent failures are illustrative. Executive Life Insurance Co. of California grew from assets of approximately \$4 billion in 1984 to approximately \$13 billion in 1989, largely through the sale of annuity contracts. See Best's Ins. Rep. (Life-Health) 751 (1990). Executive Life Insurance Co. of New York grew from approximately \$1.7 billion in assets in 1984 to approximately \$3.9 billion in 1989. See *id.* at 755. The Mutual Benefit Life Insurance Co. did not adopt a high-growth strategy until shortly before its failure, with admitted assets growing from approximately \$8.3 billion in 1984 to approximately \$11.6 billion in 1989. See *id.* at 1523. However, Mutual Benefit Life did appear to adopt a high-growth strategy after 1989, with individual life insurance in force growing from \$36.3 billion in 1989 to \$67.3 billion in 1990, an increase of 85.4% in a single year. See Jim Connolly, *Larger Companies Showed Growth Across the Board*, Nat'l Underwriter, June 10, 1991, at S2.

²²⁵ See Ruth Gastel, *Insolvencies/Guaranty Funds*, Ins. Issues Update (Insurance Info. Inst., New York, N.Y.), Aug. 1993, at 1.

may not have been economically insolvent at the time of their closures and may eventually pay creditors in full.²²⁶ As such, these early closures simply may reflect the fact that the insurance industry actually is handling its problems more effectively than the banking industry did, since early closure can prevent, or at least mitigate, creditors' losses.

Finally, the commercial real estate and junk bond markets have begun to recover, and blue chip equity securities are trading at record levels. The insurance industry also appears to have good access to new capital,²²⁷ and, on balance, it is unlikely—absent unforeseeable exogenous factors such as a stock market crash, a new recession, or a natural catastrophe—that the insurance industry will be subjected to an industry-wide insolvency crisis over the next few years.²²⁸

2. *State Solvency Regulation*

State solvency regulation of insurance companies appears in three forms: regulatory safety and soundness supervision, minimum capital rules, and guaranty funds. While these regulations appear relatively well-crafted to achieve their objectives, states are, in any case, currently proceeding to strengthen them. The National Conference of State Legislatures established a task force on insurance solvency regulation in 1990 and announced that enactment of tougher laws would be a high priority.²²⁹ Meanwhile, the NAIC has implemented solvency accreditation standards under which state regulators, to receive certification, must establish that they have adequate powers under state law and that they

²²⁶ See *New Jersey Court Appoints Conservator of Troubled Mutual Benefit Life Insurance*, 18 Pens. Rep. (BNA) No. 29, at 1240 (July 22, 1991); Jim Connolly, *Penn Mutual Is Monarch's New Manager, Nat'l Underwriter*, June 24, 1991, at 29.

²²⁷ Stock firms can also raise equity capital by selling new securities on the market. Parent corporations can and do infuse new capital into insurance subsidiaries. For example, Kemper Corp. committed \$1.8 billion in capital to back the operations of two life insurance subsidiaries which had been downgraded by Moody's Investors Services, Inc. This guaranty came on the heels of a prior injection of \$125 million in additional capital. See Laurie Cohen, *Kemper Backs its 2 Life Units*, *Chicago Trib.*, July 28, 1991, at 3.

Mutual institutions, which have been among the hardest hit by recent economic conditions, are increasingly considering demutualization (converting to stock ownership) as a means of increasing capital. Leading this movement is the Equitable Life Assurance Society of the U.S., which recently converted from a mutual to a stock institution, and which received a commitment from an investor (the French insurance firm Groupe Axa, S.A.) to infuse \$1 billion in new capital into the firm even before the planned public stock offering. See Susan Pulliam, *Equitable Life's Plan to Sell Stake Advances*, *Wall St. J.*, July 18, 1991, at A3.

²²⁸ A recent study of the industry by Professor Orin Kramer bears out these conclusions as applied to property/casualty firms. See Orin Kramer, *Insurance Info. Inst.*, *Rating the Risks: Assessing the Solvency Threat in the Financial Services Industry* 35 (1991). Professor Kramer finds that an industry-wide solvency crisis is improbable, even under pessimistic economic assumptions, and concludes that property/casualty firms are relatively strong compared to counterparts in other industrial sectors. See generally *id.*

²²⁹ See Gastel, *supra* note 225, at 1.

have the necessary resources to enforce those powers.²³⁰ The NAIC also is evaluating state regulatory agencies under this program and may adopt tougher regulations under which insurers in states failing to adopt the NAIC's model insolvency laws could be penalized.²³¹ Finally, the NAIC also has announced its own priorities for toughening solvency regulation.²³²

State insurance regulators monitor the safety of institutions under their jurisdiction by means of site examinations and analyses of report data. Insurance firms are required to file annual financial statements with their regulators. State regulators examine the data through systems developed by the NAIC,²³³ and the regulators conduct investigations in greater detail if firms are identified as potential problems by the NAIC. If these problems prove to be serious, insurance regulators take a series of increasingly severe remedial actions, beginning with intensive audits or private jawboning in minor cases, and proceeding to formal orders requiring the firm to improve its solvency by increasing capital or restructuring its investments or public remedial actions such as placing the institution in conservatorship or rehabilitation in more serious cases. The worst cases ultimately end up in receivership and liquidation.²³⁴

Every state has established a guaranty fund covering policyholders in homeowner, automobile, and other property/casualty companies,²³⁵ and most if not all have similar programs in place for life and health insurance companies.²³⁶ Most states also have workers' compensation funds. Other lines such as disability, ocean marine, mortgage guaranty, and title insurance are less than fully covered. Reinsurance generally is not covered.²³⁷ The state guaranty funds have been created over the past two decades based on a model proposed by the NAIC in 1969, but the funds differ in details such as deductibles, policy limits, and the like.

²³⁰ See *id.*

²³¹ See *id.* at 3.

²³² See *id.* These priorities include "refining the financial examination process; expanding the information provided in annual statement on material transactions; creating a reinsurance office to assist states in the evaluation of reinsurance companies and contracts; upgrading training programs for financial analysts, auditors and regulators; and setting up a special committee to study the receivership process as it applies to insolvent insurance companies." *Id.*

²³³ Economists have criticized the NAIC's analysis for failing to predict insolvency reliably. See, e.g., Robert A. Hershbarger & Geoffrey P. Miller, *The NAIC Information System and the Use of Economic Indicators in Predicting Insolvencies*, 9 *J. Ins. Issues & Prac.* 21 (1986). Somewhat greater predictive accuracy can apparently be achieved with highly sophisticated models, see Ran BarNiv & Robert A. Hershbarger, *Classifying Financial Distress in the Life Insurance Industry*, 57 *J. Risk & Ins.* 110 (1990), although none of the models proposed to date appear particularly robust.

²³⁴ See Gastel, *supra* note 225, at 12-13.

²³⁵ See *id.* at 4.

²³⁶ See *id.*

²³⁷ See *id.* at 12.

Some states deny coverage to larger corporate policyholders, on the theory that these sophisticated consumers can assess the solvency of insurance firms on their own.²³⁸ Nevertheless, the great majority of these state guaranty funds operate on an assessment system: there is no permanent fund in place, but participating insurance companies are assessed to cover payments to policyholders which are not covered by the assets of a failed institution.²³⁹ Assessments typically are paid either by means of state-mandated premium increases—in which case the costs are automatically passed on to policyholders in the form of higher prices—or through tax relief for insurance companies—in which case the effective incidence of the assessments is passed to the state's taxpayers.²⁴⁰ For example, New York, a major insurance market and home to many of the largest insurance firms, has established a unique permanent fund comparable to bank deposit insurance schemes.²⁴¹ At least one of the state assessment systems (Maine's) includes a limited permanent fund for the payment of policyholders pending collection of assessments.²⁴²

It is likely that additional legislation on guaranty funds will be adopted in the coming years. One sensible proposal would be to base assessments on some criterion of risk rather than on the basis of market share, as under current law,²⁴³ because a guaranty system that does not adjust premiums for risk is certain to induce distortions by providing a subsidy for riskier institutions at the expense of safer ones.²⁴⁴ The absence of risk-based deposit insurance premiums is a principal culprit in the recent debacle in the banking industry, and similar distortions are undoubtedly introduced into insurance markets as a result of the flat-rate premium structure under state guaranty systems.

In endorsing the use of risk-adjusted premiums, we do not mean to imply that it will be easy to determine risk. Evaluating the riskiness of an insurance firm—especially a property/casualty firm—is difficult because neither the demands for payment on the liability side of its balance sheet (policyholders' claims) nor the value or volatility of the assets on the asset side of the balance sheet can be readily quantified. There are,

²³⁸ See *id.* at 10.

²³⁹ See *id.* The assessments are collected through changes in premium tax rates, insurance policy surcharges, or changes in premium rates. See *id.*

²⁴⁰ See generally General Accounting Office, *supra* note 214. In the case of property/casualty firms, 31 states authorize the recoupment of assessments through premium increases; 17 authorize recoupment through tax relief; one allows either method; and one provides for no method of recoupment. See *id.* at 12.

²⁴¹ See Gastel, *supra* note 225, at 9.

²⁴² See *id.*

²⁴³ See *id.*

²⁴⁴ See Jonathan R. Macey & Geoffrey P. Miller, *America's Banking System: The Origins and Future of the Current Crisis*, 69 Wash. U. L.Q. 769, 801-03 (1991) (discussing Treasury Department proposal for risk-based deposit insurance premiums).

however, several sources of information about the riskiness of insurance firms which provide at least some useful information on which a tentative assessment of risk can be based.²⁴⁵ Also potentially valuable, in terms of assessing risk, is the level of capital in an insurance company. The Department of the Treasury has recently proposed a system of risk-adjusted deposit insurance premiums for banks based on a measure of risk-adjusted capital.²⁴⁶ Although not without problems,²⁴⁷ a similar measure of risk-adjusted capital might prove useful in setting insurance premium rates for insurance firms.

Another proposal, which strikes us as less sound, is to convert the existing assessment systems into prefunded plans like New York's.²⁴⁸ The advantage of a prefunded system is that the money is available immediately to meet policyholder claims. Immediate availability of funds

²⁴⁵ One agency, A.M. Best, has long published ratings for all firms in the industry, and recently the Standard & Poor's Co. has entered the field with its own credit rating system for all firms, not just those submitting to claims-paying-ability review. Moody's also rates many larger insurance firms.

It is unclear how well rating agencies do in practice. The 1990 edition of Best's Insurance Reports characterized Mutual Benefit Life as "most ably managed" in "the highest ideals of business equity" and gave the firm its highest rating of "A+ (superior)." Best's Ins. Rep. (Life-Health) 1521-23 (1990). Best's downgraded Mutual Benefit Life to a "Contingent A" a few days before it was closed, citing "uncertainties surrounding the timing and ultimate success of the company's repositioning plan and capital raising effort." Cynthia Crosson, *Mut. Benefit's A.M. Best Rating Drops One Notch, Nat'l Underwriter*, July 15, 1991, at 19. Standard and Poor's gave Mutual Benefit Life an "A" rating for overall financial health and claims-paying ability up until a few days prior to the failure. See *New Jersey Court Appoints Conservator of Troubled Mutual Benefit Life Insurance*, supra note 226, at 1240. Moody's also gave Mutual Benefit Life an "A3" rating (the lower part of the "good" category), and only downgraded it 13 notches to "Caa" a few days before its failure. See *Moody's Cuts [Mutual Benefit] Rating*, *Reuters Fin. Rep.*, July 15, 1991, available in LEXIS, Nexis Library, Wires File. Nevertheless, in fairness, it should be noted that the earlier, favorable ratings were not necessarily erroneous, since Mutual Benefit Life failed as a result of a policyholder run rather than because of any determination of insolvency. See Eric N. Berg, *Insurers' Raters Are on the Spot for Inaccuracy*, *N.Y. Times*, Aug. 4, 1991, at A1.

The rating agencies did somewhat better in the case of other prominent failures. In the case of Executive Life Insurance Co. of New York, Best's identified several of the weaknesses that precipitated its eventual failure, including losses from its sizeable bond portfolio and increased surrenders and withdrawal activity by policyholders. The ultimate rating, however, was "Contingent A (Excellent)." Best's Ins. Rep. (Life-Health) 753-55 (1990). The Executive Life Insurance Co. (in California) also received a "Contingent A (Excellent)," with the Best's report assuring readers that "[a]ctuarial studies indicate that even under a considerable economic downturn whereby significant fluctuations in interest rates and increased default rates would be experienced, together with accelerated surrender and withdrawal activity on the part of . . . policyholders, adequate liquidity is maintained to meet any further adverse experience in these areas." *Id.* at 751.

²⁴⁶ See generally U.S. Dep't of the Treasury, *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* (1991).

²⁴⁷ See Macey & Miller, supra note 244, at 790-92 (discussing flaws in Treasury Department plan for risk-adjusted capital adequacy rules).

²⁴⁸ See Gastel, supra note 225, at 9.

reduces the disruption and hardship to policyholders who would otherwise have to wait until the completion of an assessment before obtaining their funds. In the case of life insurance firms, it also reduces the danger of runs by policyholders with rights to cash in the investment value of their policies on demand.²⁴⁹ However, despite these advantages, a prefunded system has serious drawbacks. First, it creates a fund which can thereafter be used to support government regulations not reasonably related to solvency regulation, or to bail out other firms not originally participating in the fund. Second, once a well-capitalized fund is in place, insurance companies lose some of their incentive to police their peers in order to prevent assessments.²⁵⁰ A prefunded plan thus reduces monitoring incentives by the parties who would be liable for assessments under an assessment system.²⁵¹ If the federal deposit guaranty program had been an assessment system rather than a richly endowed prefunded plan, well-managed and solvent banks and thrift institutions might have organized to prevent the excessive risk taking by others in the industry which eventuated the industry's crisis.²⁵² Thus, assessment plans offer a

²⁴⁹ Such a run occurred in the case of Mutual Benefit Life in July 1991, precipitating the failure of that institution. See generally Pulliam, *supra* note 9. It should be noted, however, that New Jersey did not have a guaranty law in effect for life insurance firms at the time. It is unclear whether policyholders would have run the institution if an assessment-type guaranty law had been on the books. Further, the danger that a solvent company would have to close because of a run would be reduced if, as we recommend in this monograph, the Federal Reserve Board is brought into service as lender of last resort for the insurance industry. See notes 263-66 and accompanying text *infra*.

²⁵⁰ As a practical matter, insurance companies retain a fair degree of ability to police their peers. A firm reputed in the industry to be managed in an excessively risky or improper manner may find it difficult to obtain adequate reinsurance, for example. If the firm uses independent agents for distribution, it may find that agents are loath to recommend its product to customers. See Producers and Insolvencies, Nat'l Underwriter, May 28, 1990, at 44 (insurance regulators want brokers and agents to provide them with information about the financial health of insurance firms, and to exercise due diligence and reasonable care when placing insurance with a company). Insurance firms also exercise influence with state insurance regulators, and may encourage the regulators to take prompt action to address problems in insurance firms which others in the industry believe to be unsafe or unsound.

²⁵¹ Of course, even in a prefunded plan the parties required to replenish the fund in the event of payouts retain some monitoring incentive. However, if the fund is solvent enough, it may effectively replenish itself through investment income. And even if some assessments are made, the existence of a fund for the payment of assessment contributes to a breakage in the connection between the failure of an insurance company and the liability of another to pay an assessment.

²⁵² Along these same lines, we question why under existing state plans assessments should be paid by means of premium increases or, worse, by tax relief for insurance firms. These payment methods operate virtually invisibly, and pass the incidence of the assessments on to groups which are not well equipped to monitor the behavior of insurance firms in the state—policyholders and taxpayers. To induce optimal monitoring and mitigate the incentives for risk taking that are built into any fixed-premium insurance system, the assessments ought to run against parties well equipped to engage in appropriate monitoring. These parties are other insurance firms in the state. Rather than being paid wholly by policyholders or taxpayers,

preferable alternative to prefunded plans along the lines of the New York scheme, and the present degree of solvency regulation at the state level appears adequate overall.²⁵³

3. *Proposals for a New Federal Role in Solvency Regulation*

Proposals currently circulating inside the Capitol Beltway to subject the insurance industry to federal oversight include Congressman John Dingell's plan to create a federal insurance agency with broad powers to

assessments should be paid partly by the insurance firms covered by the guaranty fund, in proportion to the volume of business conducted by the firm in the state, with suitable adjustment for the riskiness of the firm being assessed. Moreover, to the extent that assessments are paid out of tax dollars, rather than from insurance companies directly, it would be better for these funds to be obtained from taxpayers in some relatively public manner calculated to induce political accountability, rather than through the nearly invisible method of tax relief for insurance companies, as is the case under current state guaranty systems.

It also is important to note that some of the benefits of prefunded plans can be achieved through suitable modifications in assessment plans. For example, most states have revised their plans to allow policyholders early access to the assets of a failed institution ahead of the claims of other creditors. See Gastel, *supra* note 225, at 10-11. For instance, Maine has created a limited prefunded plan to pay off policyholders in the short run; this may draw a more reasonable balance between the need to pay off policyholders quickly and the value of peer group monitoring that assessment plans provide. *Id.*

²⁵³ Another, more appealing, proposal for reform in the insurance industry is the suggestion that the states enter into an interstate compact subject to the federal oversight inherent in the requirement of congressional approval. See U.S. Const., art. I, § 10, cl. 2. James M. Jackson, the leading proponent of this proposal and Vice President and Deputy General Counsel of Transamerica Life Insurance Co., describes the idea as follows:

By utilizing the "compact clause" of the federal constitution . . . the states have the power to institute any uniform standards, rules, and enforcement mechanism deemed necessary and appropriate. . . .

. . . .
 . . . An interstate compact occupies a position of overriding authority with respect to other statutory law, whether previously or subsequently adopted. The reason . . . is that in addition to being [a] statute, an interstate compact also constitutes an enforceable contract among all the states which become party to it. . . . Compacts thus provide a constitutional, statutory, and contractual basis for uniform state regulation.

James M. Jackson, *A New Dimension for State Regulation*, Nat'l Underwriter, Nov. 19, 1990, at 21.

An interstate compact would theoretically permit the NAIC or some other body chosen by the states as a central regulator to exercise compulsory authority over the separate state insurance departments, and would obviously increase the NAIC's power, since the NAIC currently operates as a purely voluntary organization without the political power to compel action by state regulators or insurance companies.

An interstate compact could establish a national association of state insurance regulators with powers to centralize information gathering and retrieval functions and to promulgate uniform rules in areas where interstate differences pose special difficulties. Such a national association could, for example, compile and maintain information about the financial condition of insurance firms on a nationwide basis; it could establish uniform standards for when an insurance company is in financial difficulty; it could assist in administering receiverships of failed institutions that operate interstate; and it could even promulgate uniform capital adequacy standards for firms doing business across state lines.

displace state regulatory authority.²⁵⁴ This proposal would establish a federal insurer solvency corporation with authority to supervise industry self-regulatory organizations (SROs), which then could authorize an insurance company to conduct interstate business free of the substantive regulation of any state of domicile.²⁵⁵ The result would be a form of federal chartering of insurance, which would create a structure for the insurance business similar to the dual banking system now in place for depository institutions.²⁵⁶ The federal regulator would set minimum standards for fundamental matters—such as accounting, investment, capital, and surplus—which states would have to equal or exceed in order to be accredited to regulate insurers in interstate commerce.²⁵⁷ The federal regulator also would exercise authority over the reinsurance business and would have the power to close insolvent or shaky insurance companies.²⁵⁸

As such, the Dingell proposal essentially would federalize insurance regulation, subject only to vestigial state regulatory oversight. If enacted, it most probably would lead to the eventual atrophy of state insurance oversight except in the key area of rate regulation, which explicitly would be left to state control under current versions of the proposal.²⁵⁹ Unlike other forms of regulation, state rate regulation would likely be more stringent under the Dingell proposal for several reasons. Deprived of most other regulatory authority, state insurance regulators would be likely to return aggressively to rate regulation as a means of maintaining some of their traditional powers. Expanded rate regulation also would offer the opportunity for the industry to bring cooperative price-setting activities within the shelter of the state action doctrine, as discussed previously.²⁶⁰ Some consumer groups also would favor substantive rate regulation as a means of rolling back rates they consider to be too high. Moreover, in an environment of federal solvency regulation, states might see the benefit of forcing below-market rates on insurers on the basis that customers in other states could compensate for the shortfall. The Dingell proposal, in other words, would tend to stifle features of state regulation that have proven successful, while maintaining and even enhancing features that are problematic from the standpoint of social

²⁵⁴ See Frederick Rose, *Congressional Proposals on Insurance Would End Primacy of State Regulation*, Wall St. J., Aug. 5, 1991, at B4.

²⁵⁵ See *id.*

²⁵⁶ For background on the dual banking system, see generally Butler & Macey, *supra* note 20; Miller, *supra* note 158; Kenneth Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 Stan. L. Rev. 1 (1977).

²⁵⁷ See Rose, *supra* note 254, at 133.

²⁵⁸ See *id.*

²⁵⁹ See *id.*

²⁶⁰ See notes 178-92 and accompanying text *supra*.

policy.

Senator Howard Metzenbaum has offered an alternative vision of reform, in which a federal guaranty fund for insurance policyholders would displace the existing state guaranty funds.²⁶¹ In our view, this idea is flawed as well. As the catastrophes over the past few years in the two principal guaranty funds for banking institutions—the Bank Insurance Fund and the Federal Savings and Loan Insurance Corporation—have shown, the last thing the federal government should be doing is entering into another open-ended contingent obligation with enormous potential risk exposure. Concern about federal budget deficits alone should cause the concept of a vast new program of federal insurance guaranties to be greeted with horror. This is particularly true since there is no reason to believe that a federal insurance fund will be any less subject to the problems of moral hazard and perverse incentive structures that doomed the federal deposit insurance funds over the past few years.

Further, it seems clear that, to the extent guaranty funds exist at all, they are better administered at the state level than at the federal level. It should be noted that most state guaranty funds cover only in-state depositors. This limitation in coverage creates a system in which insurance regulators in other states have a strong incentive to monitor the solvency regulation of a company's domiciliary state in order to reduce the claims on their own insurance guaranty systems. The advantages of this monitoring of one state's regulator by regulators in other states would be lost if state guaranty schemes were displaced by a single federal insurance fund. Moreover, a federal guaranty system would aggravate further the existing temptation on the part of some states to expropriate the wealth of citizens of other states by imposing below-market rate regulation.²⁶²

These considerations suggest that a federal guaranty program for insurance policyholders would be ill-advised. They also imply that if

²⁶¹ See text accompanying notes 235-36 *supra*.

²⁶² In an interesting recent paper, economist Benjamin Zycher explores the probable impact of federal solvency regulation on state rate setting. See generally Benjamin Zycher, *Insurance Rates, Direct Democracy and Solvency Regulation* (1991) (on file with the New York University Law Review). Zycher observes that if the federal government were to regulate the solvency of insurance companies by displacing state guaranty programs with a federal guaranty fund, state rate-setting bodies inevitably would face irresistible political pressure to set rates below the market-clearing rate. By setting rates at low levels, states could confer benefits on their own citizens at the expense of insurance firms and the federal guaranty fund. Eventually some of the insurance firms would fail as a result of continuing losses, but the costs of the failures would be borne by the federal insurance fund. As in the banking industry, the result of federal intervention would be to impair the solvency of the insurance industry. It would also restrict the supply of insurance, thus harming the policyholders it was ostensibly designed to protect. Zycher observes that these perverse regulatory results would not occur if solvency regulation were administered at the state level, since interests within a state would bear the costs of the state's setting insurance rates at unreasonably low rates.

such a program were adopted, the administrator of the federal guaranty fund inevitably would become involved in rate regulation. To protect the assets of the guaranty fund, the federal administrator would have to supervise the safety and soundness of the institutions under the fund; such supervision cannot be accomplished effectively if states maintain plenary control over rate setting. Federal guaranties accordingly would broaden into generalized federal oversight of the substance of state regulation, including state rate regulation. The notion of a dual system with a federal guaranty fund and state regulation of the business of insurance outside the solvency area is therefore unstable and likely would lead eventually to broader, preemptive federal oversight of many aspects of the insurance business.

A final proposal for federal oversight would be to establish the Federal Reserve Board (Federal Reserve or Fed) as a lender of last resort for the insurance industry. The recent failure of Mutual Benefit Life Insurance Company²⁶³ brought to public attention the fact that many life insurance companies operate with the equivalent of demand or near-demand debt in their balance sheets. Policyholders have the power to liquidate the cash value of their annuities and guaranteed investment contracts on demand or subject only to a brief notice period.²⁶⁴ This demand and near-demand debt creates the possibility of runs based on information, whether or not accurate, that the company is in dire financial straits. The exposure of some life insurance firms to this kind of run is very large,²⁶⁵ and has induced major rating firms to consider the risk of runs as a factor in their evaluation of insurance firms' credit.²⁶⁶

Property/casualty firms are subject to a related, but slightly different, risk. A major earthquake or other extraordinary disaster could result in tens of billions of dollars of claims being made on the assets of property/casualty firms within a very short time span. Faced with these claims, these firms must liquidate their assets rapidly, resulting in "fire-sale" losses. Some firms with relatively illiquid asset portfolios might be unable to pay out claims when due. Regulators might be required to close firms as a result, even though they might be perfectly solvent if given adequate time to liquidate their assets in an orderly fashion.

We believe these considerations demonstrate the value of a lender of last resort for the insurance industry—an entity that can advance tempo-

²⁶³ See note 9 and accompanying text *supra*.

²⁶⁴ See Eric N. Berg, *Rater to Add Policyholder Panic Factor*, N.Y. Times, Aug. 2, 1991, at C1.

²⁶⁵ In the case of Mutual Life Insurance Co. of New York, for example, \$9.8 billion of its \$14 billion in liabilities could be withdrawn on demand or on short notice. See Richard D. Hylton, *MONY, Sorely Tested, Reassures Customers*, N.Y. Times, Aug. 2, 1991, at D1.

²⁶⁶ See Berg, *supra* note 264, at C1.

rary liquidity assistance to solvent firms to tide them over until they can liquidate sufficient assets to pay off the demands of policyholders. The only suitable lender of last resort at either the state or the federal level is the Federal Reserve, since there are no state agencies with sufficient capitalization to provide this kind of liquidity assistance. The Federal Reserve already performs a similar lender-of-last-resort function for the banking industry.

In suggesting that the Federal Reserve perform this function, we wish to emphasize that the loans should be truly a matter of last resort. Even if authorized to provide liquidity assistance to insurance firms, the Fed should not do so unless it appears that all other feasible sources of funds have evaporated. Further, the Fed should provide lender-of-last-resort financing only for temporary liquidity assistance to solvent firms. In no event should federal assistance be provided to firms that are insolvent. Further, any temporary liquidity assistance should be fully secured or oversecured by marketable collateral. In most cases, such collateral would be readily available in the form of privately placed debt which cannot be liquidated quickly at market rates, but which nevertheless has collateral value. Moreover, before the Fed intervenes with assistance, it should receive a certification from the insurance commissioner of the firm's domicile that the firm is not insolvent. In addition, the relevant state guaranty funds might be required to bear a substantial amount of the insolvency risk, by means of agreements to indemnify the Fed in the event that the emergency loans are not repaid and the collateral proves insufficient to satisfy the shortfall.

With these safeguards in place, the Fed should have adequate assurance of prompt repayment when it advances temporary liquidity assistance. Accordingly, we do not believe that temporary liquidity assistance by the Federal Reserve needs to be accompanied by any other form of federal solvency regulation.

C. Rate Regulation

While the various legislative packages under consideration do not purport to establish federal rate regulation, the proposed federal solvency regulations could have an indirect but marked impact on this major area of state insurance regulation. The importance of the issue of rate regulation to the states should not be underplayed: in addition to solvency regulation, the various mechanisms for setting insurance rates and policing against deviations from filed rates through rebating comprise the other major prong of state insurance regulation.

The systems of rate setting at the state level are anomalous, in that insurance is the only major U.S. industry which is both highly unconcen-

trated—almost all markets are served by a large number of firms, and no firm controls enough of the market to exercise market power—and yet subject to price controls in most of the states. In this Section, we describe the state rate-setting regimes and then consider the arguments for and against rate regulation, as well as the impact of proposed federal solvency regulation on state rate-setting programs. We conclude that insurance rates should be set by market forces rather than by any form of governmental regulation.²⁶⁷

1. *State Insurance Commissions*

The states generally have adopted two approaches to rate setting, each with several variants.²⁶⁸ Most states—approximately thirty in the case of property/casualty insurance—follow the traditional practice²⁶⁹ of requiring that rates be approved in advance by the regulator.²⁷⁰ A few states, including Massachusetts, require the regulator to set the rate; in others, the regulator reviews a rate filed by the insurance company itself or by an independent insurance rating bureau.²⁷¹ One typical pattern (sometimes referred to as “flex rating”) allows the state to define a range in which rates can fluctuate from a defined baseline.²⁷² In practice, many state systems allow for considerable deviation from the filed rates. Commercial filings in some states, for example, can be legally modified by as much as seventy percent.²⁷³ Actual rates rarely deviate this much from filed rates, but they may be changed by as much as fifty percent in volatile markets.²⁷⁴

The remaining states do not require prior approval of rates but instead allow rates to be set by market forces.²⁷⁵ Most of these states require that rates be filed prior to or soon after use, and retain the power to

²⁶⁷ Cf. AEI Study, *supra* note 12, at 89 (concluding that “rigid state rate regulation has had adverse effects” and that “vigorous competition is consistent with the goal of reasonable rates”).

²⁶⁸ State power to control rates was upheld by the Supreme Court in 1914, see *German Alliance Ins. Co. v. Lewis*, 233 U.S. 389 (1914), and has not seriously been questioned since.

²⁶⁹ The system of prior state approval of rates is recommended in the NAIC’s “All Industry” model statute, promulgated in 1945 at the time of the enactment of the McCarran-Ferguson Act. See Gastel, *supra* note 60, at 9, 10.

²⁷⁰ See Insurance Info. Inst., *supra* note 155, at 13.

²⁷¹ See Gastel, *supra* note 60, at 9.

²⁷² See *id.*

²⁷³ See Gerald D. Stephens, *Please, No More Complaints*, *Best’s Rev.*, Sept. 1991, at 61.

²⁷⁴ See *id.*

²⁷⁵ States began to adopt these competitive rate-setting programs in the 1970s. See Gastel, *supra* note 225, at 9. It should be noted that California’s Proposition 103 represents a return to the older system of prior approval, albeit with a view toward benefiting consumers rather than insurance firms. See notes 279-80 and accompanying text *infra* (discussing Proposition 103).

reject rates deemed unfair, unreasonable, or excessive.²⁷⁶ The stringency of this post hoc review process varies from state to state. Some states, such as Illinois, provide only minimal state oversight, relying on market forces to ensure the fairness of rates.²⁷⁷

Over the past few years, state rate-setting activity has become highly controversial due to consumer-oriented reforms, including rate rollbacks and structural rate-making reform. Rate rollbacks have typically been the result of states intervening to hold down rates in particularly sensitive lines such as automobile insurance.²⁷⁸ The most prominent recent example is California's Proposition 103,²⁷⁹ which, among other things, repealed the state antitrust exemption for insurance firms, eliminated its anti-rebate law, and required advance administrative approval for rates.²⁸⁰ Texas's comprehensive insurance reform of June 1991 also contains many "pro-consumer" features, although it rejected rate regulation for a general scheme of deregulation in lines such as general liability and commercial property insurance. These lines are now subject to a "file-and-use" requirement that does not require prior administrative approval.²⁸¹

In addition to rate rollbacks, some states have adopted structural reforms of their rate-setting proceedings—changes which in the long run may have a greater impact than the more highly publicized rate rollbacks. One such structural reform has been the move toward popular election of state insurance commissioners to make them more accountable to the public and presumably less influenced by insurance industry lobbyists.²⁸² A second important structural reform has been to change

²⁷⁶ See Insurance Info. Inst., *supra* note 155, at 13.

²⁷⁷ See Stephens, *supra* note 273, at 61.

²⁷⁸ Massachusetts regulators have reportedly been holding automobile insurance rates below market-clearing rates. See Muhl, *supra* note 137, at 28.

²⁷⁹ Codified at Cal. Ins. Code § 1861.01-.16 (Deering 1992).

²⁸⁰ See *id.* Proposition 103 also allowed banks to sell insurance, required an immediate 20% reduction in automobile, homeowners', commercial, and municipal liability rates, and froze rate increases for a year subject to a limited waiver for cases where the insurer could establish that it was substantially threatened with insolvency. See *id.*

²⁸¹ See Fayhee, *supra* note 131, at 6. Other lines, such as private passenger auto, commercial auto, and personal property insurance, are subject to more stringent regulation, but even for these lines a firm may file and use a rate, without prior approval, so long as it remains within a "flex band" of the administratively-established benchmark rate. See *id.*

²⁸² If recent experience in California is illustrative, this move to elected officials may affect insurance regulation in relatively significant ways. Early in 1991, the newly-elected insurance commissioner of that state, John Garamendi, received widespread publicity by announcing that insurance company capital not used to write business in California would henceforth be included in the rate base and indicating that he intended to rescind rate increases approved by his predecessor in office. See Wojcik, *supra* note 128, at 1. Mr. Garamendi vowed to "put bigger rollbacks in consumers' pockets and crack down on excessive rates in the future." See *id.* Consumer advocate Ralph Nader praised the new commissioner, observing that "because the former regime so arrogantly refused to enforce the will of the people, the new commis-

the procedures for rate setting by providing consumer and public interest representatives explicit representation in rate-setting procedures.²⁸³

Nevertheless, consumer legislation of this sort sometimes results in a transfer of wealth from insurance firms to consumers. A number of studies of Proposition 103 have documented significant negative impacts on insurance company stock prices in the days surrounding the election in which Proposition 103 was adopted.²⁸⁴ These wealth effects do not in themselves establish that Proposition 103 and like programs are undesirable as a matter of social policy. If insurance companies have been systematically overcharging, as consumer advocates claim, the rate roll-backs

could actually increase the efficiency of insurance markets relative to the current system, although it is very unlikely that administered rates of the sort now enforced in California would be more efficient than rates set by market forces. However, if rates are set too low, there is an obvious threat to insurance company solvency. Thus, while it is too early to say whether state rate-rollback legislation actually threatens the solvency of insurance firms, ratings companies like the A.M. Best Company have issued qualified ratings for firms exposed to the financial uncertainties of regulatory programs in California, New Jersey, Kentucky, Massachusetts, Michigan, New York, North Carolina, Pennsylvania, and South Carolina.²⁸⁵

2. *Market Forces*

The traditional argument in favor of state rate regulation is that state control over rates is necessary in order to protect consumers.²⁸⁶

sioner's responsibility is clear." *Id.* This kind of regulatory populism plays well at the ballot box, and can be expected to occur more frequently as other states move toward elected insurance commissioners.

²⁸³ Texas, for example, now requires that a consumer advocate be allowed to participate in insurance rate-setting proceedings. See Tex. Ins. Code Ann. arts. 135A, 5101 (West Supp. 1993). In addition, California's Proposition 103 created a "consumer advocacy corporation" to represent consumer interests in insurance matters, but the California Supreme Court struck the provision down as violative of the state constitution. See *Calfarm Ins. Co. v. Deukmejian*, 771 P.2d 1247, 1263 (Cal. 1989).

²⁸⁴ See generally Joseph A. Fields, Chinmoy Ghosh, David S. Kidwell & Linda S. Klein, *Wealth Effects of Regulatory Reform: The Reaction to California's Proposition 103*, 28 J. Fin. Econ. 233 (1990); Shelor & Cross, *supra* note 132; Samuel H. Szewczyk & Raj Varma, *The Effect of Proposition 103 on Insurers: Evidence from the Capital Market*, 28 J. Risk & Ins. 671 (1990).

²⁸⁵ See Paul E. Wish, *Review and Preview: 1990 and 1991, Best's Rev.*, Sept. 1991, at 14.

²⁸⁶ Historically, rate regulation entered the insurance business during the populist era of the early twentieth century. Many states, over the vigorous opposition of the insurance industry, asserted the power to set rates and used that power to force insurance companies to lower the rates that they previously had been charging. Kansas and Texas enacted the first rate regulation statutes in 1909 and quickly decreed reductions in insurance rates. See generally H.

The argument has two main strands: first, that by virtue of their power and superior bargaining position insurance companies are likely to overcharge consumers unless the state controls the permissible rates; and, second, that insurance contracts are highly complex instruments which are difficult for consumers to understand and compare. Although these arguments are often lumped together, they are conceptually distinct: the first is premised on bargaining power, and the second is based on information costs. In one form or another, these are the principal justifications for rate regulation heard today.

We find these arguments unpersuasive. There is little reason to suppose that a state can do a better job than the market at setting rates. Insurance rates, like any other prices, should be set by market forces under conditions of free competition. Any system of administered rates carries with it serious dangers of marketplace distortions. This is true regardless of whether rates are rolled back—as is happening in California and other states with consumer reform legislation on the books—or maintained at excessively high rates in order to enrich the coffers of insurance firms.

Some consumer advocates may believe that a return to administered prices, such as that seen recently in California, ensures that prices will not be set too high. But if the history of insurance regulation is a guide, populist revolts against insurance pricing rarely endure for long. Many states adopted price regulation during the populist revolt of the early twentieth century, and the initial experience under these systems was unfavorable to the insurance industry.²⁸⁷ Over time, however, the industry established influence over all or nearly all state insurance commissions, and before long the power to administer prices was being utilized to approve and enforce rates set by industry rating bureaus that operated, at the time at least, as little more than highly efficient and well-organized cartels.²⁸⁸ It is quite possible that when the fervor of the current populist revolt over insurance rates dies down—as it inevitably will—the industry will be able to reassert its power and even to turn administered pricing systems to its own advantage.²⁸⁹

Roger Grant, *Insurance Reform: Consumer Action in the Progressive Era* (1979).

²⁸⁷ See *id.* at 55-70.

²⁸⁸ This story of industry regulation is well-documented in the standard histories of the industry, most notably in H. Grant, *supra* note 286. See also M. Keller, *The Life Insurance Enterprise, 1885-1910* (1963). Grant and other historians, however, miss many of the implications of their own evidence because of their failure to appreciate the importance of cartels in the development of the industry in the period they study.

²⁸⁹ The danger of cartelization under the guise of rate setting is somewhat reduced by the structural reforms, discussed earlier, see notes 282-83 and accompanying text *supra*, which attempt to impose a political check on industry capture of state insurance commissions. Such structural reforms may have an impact, but whether they will endure as effective checks on

In addition to the market distortions and shortages caused by state rate regulation, there are the costs of administering such systems to consider. In the scheme of things these costs are fairly small—Proposition 103 reportedly added \$25 million to the budget of California's insurance department²⁹⁰—they are not insignificant and suggest another, albeit marginal, reason for not imposing a system of administered price regulation on a highly competitive industry such as insurance.

State-administered rates might have some appeal if it could be shown that private market forces would not work effectively to set rates at appropriate levels. There is no evidence, however, that if suitable anti-trust protections were in place, the industry would not set rates at efficient levels. Such evidence as exists suggests the contrary. For example, Illinois, which went to free-market rate setting for most lines in 1971, has experienced no serious difficulties with rates. Premiums in Illinois for automobile and homeowners' insurance are substantially lower than those in other industrial metropolitan states.²⁹¹

The insurance industry is ideally suited to rate setting by competitive forces. As economist Paul Joskow has observed:

[T]he property-liability insurance industry possesses the structural characteristics normally associated with the idealized competitive market: a large number of firms, operating in a market with low concentration levels, selling essentially identical products, provided at constant unit costs and with ease of entry of new and potential competitors. . . . It is . . . difficult to find . . . many other industries which conform more closely to the economist's idealized competitive market structure.²⁹²

Joskow's comments about the property-liability industry apply equally well to the life insurance industry, in which there are also many producers selling very similar products. Based on these observations about industry structure, Joskow suggests that insurance rates and rating classifications should not be regulated at all:

There are no natural monopoly characteristics which would indicate that open competition would be unstable and eventually lead to monopoly. Rather, the argument has been that rate making in concert through rating bureaus is a necessity to insure the public and the industry against "destructive" competition and large numbers of bank-

capture in the long run remains to be seen.

²⁹⁰ See Stamp, *supra* note 62, at 45.

²⁹¹ See *id.* at 48. An earlier study, however, found no evidence that rates for automobile insurance are higher in states with prior approval laws than in states without prior approval laws. See Richard A. Ippolito, *The Effects of Price Regulation in the Automobile Insurance Industry*, 22 J.L. & Econ. 55 (1979).

²⁹² Paul Joskow, *Cartels, Competition and Regulation in the Property-Liability Insurance Industry*, 4 Bell J. Econ. & Mgmt. Sci. 375, 391 (1973).

ruptcies. There does not seem to be any reason why this industry should be more unstable than others.²⁹³

Consumer groups may seek state rate regulation because they see state regulation as a means for rolling back rates and accomplishing other policy objectives. Insurance regulators may favor rate regulation because they perceive that increased state control over rates will expand their powers, their budgets, and their political standing. And insurance companies may favor rate regulation as a shield against the federal anti-trust laws. Thus, a potent political coalition in favor of enhanced state rate regulation might well develop.

However, increased state involvement with the rate-setting process would not be a constructive development because the rates as set are unlikely to track market-clearing rates. Instead, they would reflect alignments of political power within a given state. At times when "consumer" interests are strong, the rates likely would be set below the market-clearing rates, resulting in losses to insurance companies and distortions in the production of insurance products.²⁹⁴ At other times, when industry groups are more powerful, rates likely would be set too high, resulting again in wealth-reducing distortions in insurance markets, as too little insurance would be purchased. Neither of these results would be desirable from the standpoint of either consumers or the general public.

Our conclusion, in short, is that states should not set rates for insurance products. This does not mean, however, that the *federal* government should set rates. As uneconomical as state rate setting would be, federal rate setting would likely be worse, since it would be very difficult, at the federal level, to take account of regional or local conditions which affect the profitability of different insurance products. Accordingly, we conclude that *neither* the states *nor* the federal government should set insurance rates.

This suggests that in an ideal world the federal government would adopt legislation which would not only disclaim any purpose to set rates at the federal level, but which also would preempt state efforts to set rates administratively. We do not recommend preemptive federal legislation at this time, however, both because the need for it is not yet clearly established, and because corrective forces acting in the private sector may be sufficient to head off any major return to rate regulation by individual states.

We do recommend, however, a more limited federal preemption of

²⁹³ *Id.* at 423.

²⁹⁴ The short-term consequence of rates set below the market-clearing rate likely would be the excessive purchasing of insurance by persons wishing to take advantage of the below-market rates. In the long term, however, the result likely would be the underproduction of insurance as firms leave the market to avoid incurring additional losses.

state regulatory authority. As already noted, the threat that rates will be set too low has been checked historically by the ability of insurance firms to exit markets which become unattractive due to adverse regulatory policies.²⁹⁵ Recently, some states have implemented, or have considered implementing, penalties or "exit fees" to deter firms from leaving markets in response to state regulatory initiatives. These "lock-in" rules undermine longstanding marketplace checks against state expropriation of insurance industry assets. In the long run, they may well harm consumers (by reducing the supply of insurance), undermine industry solvency, and spark an unhealthy competition in which states vie to set rates at unrealistically low levels in order to benefit their own citizens at the expense of citizens of other states. The problem of exit fees is serious enough to warrant a limited preemption to prohibit states from penalizing any firm that elects either to leave a state altogether or to leave any line of insurance within a state, when the firm's decision is based on economic cost factors and is not part of any boycott or cooperative enterprise intended to pressure the state to alter or amend its regulations.

CONCLUSION

This Article has reexamined the structure of regulatory federalism established by the McCarran-Ferguson Act. With respect to the anti-trust exemption, we conclude that the boycott exception to the McCarran-Ferguson Act should be interpreted to permit vigorous enforcement against industry practices that suppress or threaten to suppress competition. Similarly, state action immunity should be limited to situations in which the activity in question is both (a) endorsed by state legislation or regulation, and not merely permitted as a matter of administrative practice or authorized by implication, and (b) subject to active, continuous, and meaningful state oversight. At the same time, there are good reasons for retaining the antitrust exemption for a fairly wide range of cooperative activities within the industry, including the compilation and dissemination of historical and prospective loss cost data and the production of nonexclusive standardized forms and policies. It thus may be useful to formulate explicit safe-harbor legislation in the future to protect those cooperative activities if the McCarran-Ferguson Act is repealed or revised by Congress, or interpreted by the judiciary in such a way as to raise questions about the legality under federal antitrust law of such legitimate cooperative activities.

Furthermore, we do not believe it is appropriate at this time to institute federal solvency regulation. Despite recent failures, the insurance industry is not now undergoing a solvency crisis, and the overall per-

²⁹⁵ See note 130 and accompanying text *supra*.

formance of state insurance regulators at safeguarding insurance company solvency has been adequate—in stark contrast to the abysmal failure of federal banking regulators to ensure the solvency of that industry. Limited federal involvement through an interstate compact, however, might be a useful means for rationalizing and coordinating state regulatory programs.

We further conclude that there are no good arguments for government control over rates in this highly unconcentrated, potentially competitive industry. Rates should be set by market forces. In light of the trend among the states toward market rate setting, which only recently has been interrupted by an unfortunate regression toward administered rates in several states, we conclude that the time is not yet ripe for preemptive federal regulation displacing state authority over insurance rates. We do recommend, however, that the federal government preempt state “lock-in” rules that penalize firms wishing to exit a state altogether or to cease offering a line of insurance within a state, when the firm’s decision to leave is based on economic cost considerations and is not part of any plan or agreement to boycott a state in order to pressure regulators to change their regulations.

The insurance industry is now undergoing enormous marketplace and regulatory strains, and calls for federal intervention have reached a fever pitch. Nevertheless, a considered study of the industry reveals that the appropriate resolution of its existing problems requires less federal involvement than conventional wisdom might suggest.